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No. 81-

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court of Appeal of the State of California for the First Appellate District

JURISDICTIONAL STATEMENT

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QUESTION PRESENTED

Whether requiring the income of foreign subsidiaries of a domestic corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the foreign commerce and due process clauses of the federal constitution, and in conflict with well established federal tax policy, when:

1. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries; and

2. The inclusion of the foreign subsidiary income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and double taxation of the foreign subsidiary income through misattribution of that income to California.

TABLE OF CONTENTS

	Page
Question presented	i
Opinions below	2
Jurisdiction	2
Constitutional, statutory and regulatory provisions	2
Statement	3
The question presented is substantial	7
I	
The decision below incorrectly decides important constitutional questions, not previously decided by this court, which are squarely presented in this case	7
A. The considerations enunciated in Japan Line apply to the Foreign Commerce Clause issued in this case and require use of the separate accounting method	8
B. The extension of unitary apportionment to Container and its foreign subsidiaries produces such misattribution of foreign source income to California as to violate the due process as well as foreign commerce clauses	15
C. Due process requires that the operations treated as part of the unitary business must be "functionally integrated" in a substantial manner well beyond what exists in this case	21
II	
The decision below permits and encourages a continuing and substantial discriminatory tax burden on multinational corporations affecting America's foreign commerce and conflicts with well-established federal policy	24
Conclusion	27

TABLE OF CONTENTS

APPENDIX

		Page
A.	California Court of Appeal Opinion	A- 1
B.	California Superior Court Opinion	A-27
C.	A List of Container's Parent and Non-100 Percent Owned Affiliates	A-34
D.	Petition for Rehearing in California Court of Appeal	A-35
E.	Petition for Hearing in California Supreme Court	A-36
F.	Notice of Appeal	A-37
G.	Title 18, California Administrative Code, § 25120(b)	A-39
H.	United Nations, Monthly Bulletin of Statistics, December 1972, Table 57	A-41
I.	United States Tariff Commission, T.C. Publication 473, Competitiveness of U.S. Industries (1972)	A-43

TABLE OF AUTHORITIES CITED

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Page

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Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924) 15, 17, 22

Butler Brothers v. McColgan, 315 U.S. 501 (1942) 22

EMI Ltd. v. Bennett No. C-79-2145 (N.D. Cal. 1980), appeal docketed, No. 80-4114 (9th Cir. Mar. 13, 1980) 15

Exxon Corp. v. Department of Revenue of Wisconsin, 447 U.S. 207 (1980) 22

Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 8, 9, 12, 13, 15

Mobil Oil Co. v. Vermont, 445 U.S. 425 (1980) 16, 17

Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) 22

Norfolk & Western Railway v. Missouri Tax Commission, 390 U.S. 317 (1968) 20

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) 22

Zschernig v. Miller, 389 U.S. 429 (1968) 24

State:

Ash Grove Cement Co. v. Department of Revenue [1977 Transfer Binder] Or. T.R. (CCH) ¶ 203-221 23

Beecham, Inc., Appeal of (SBE 1977) Cal. Tax Rep. (CCH) ¶ 205-635 3

Commonwealth v. ACF Industries Inc., 441 Pa. 129, 271 A.2d 273 (1970) 23

Safeway Stores Inc. v. Franchise Tax Board, 3 Cal. 3d 745, 91 Cal. Rptr. 616 (1970) 10

Table of Authorities Cited

Constitution

	Page
U.S. Const. art. I, § 8, cl. 3	3
U.S. Const. amend. XIV, § 1	3

Statutes

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Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Before the S. Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (Statement of Lawrence N. Woodworth)	14

TABLE OF AUTHORITIES CITED

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Page

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JURISDICTIONAL STATEMENT

Appellant, Container Corporation of America ("Container") appeals from the judgment of the Court of Appeal, of the State of California for the First Appellate District, ("Court of Appeal"), which upheld the right of the Franchise Tax Board of the State of California, in determining the taxable income of appellant to be apportioned to California, to include the income of subsidiaries of Container organized and operating exclusively outside the United States. Pursuant to Supreme Court Rule 28.1 a list of Container's parent and non 100 percent owned affiliates is found at Appendix C below.

OPINIONS BELOW

The opinion of the Court of Appeal (Appendix A) is reported at 117 Cal.App.3d 988, 173 Cal.Rptr. 121 (1981). The memorandum opinion and judgment of the California Superior Court (Appendix B) are not reported.

JURISDICTION

The Court of Appeal rendered its opinion and judgment on April 17, 1981, affirming the California trial court's judgment. Appellant's petition for rehearing was filed April 29, 1981, and was denied by the Court of Appeal on May 4, 1981 (Appendix D). Appellant's petition for hearing in the California Supreme Court was filed May 22, 1981, and was denied June 17, 1981 (Appendix E).

A notice of appeal was filed in the Court of Appeal on July 31, 1981 (Appendix F). The time within which to docket this appeal in this Court expires on September 15, 1981, and timely docketing has been made. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(2).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS

California Revenue and Taxation Code, Section 25101 provided (during the tax years at issue, 1963-1965) as follows:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll,

> value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State. . . .

California Administrative Code, title 18, section 25120(b) is set forth in Appendix G.

The relevant provisions of the Constitution are the Foreign Commerce Clause (U.S. Const. art. I, § 8, cl. 3), and the Due Process Clause of the Fourteenth Amendment.

STATEMENT

1. California imposes a franchise tax based on net income on corporations doing business in California. The tax base for a single corporation or a unitary group of corporations doing business in several states is apportioned according to the familiar payroll, property and sales factors formula. Unlike most other states in the United States[1], however, California also includes separately incorporated subsidiaries operating exclusively in foreign countries in the tax base to be apportioned where the corporations are determined to be unitary.[2] This appeal challenges

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[1]Carlson, *State Taxation of Corporate Income From Foreign Sources*, in Essays in International Taxation (Tax Policy Research Study Number Three, Department of the Treasury), 231, 245 n.1 (1976), citing Rudolf, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171 (1970).

[2]In addition, California includes a foreign parent and its affiliates operating exclusively in foreign countries in the tax base where a subsidiary is operating in California. Appeal of Beecham, Inc. Cal. Tax Rep. (CCH) ¶ 205-635, Cal. State & Local Tax Serv. (P-H) ¶ 13,102-I (St. Bd. Equal. 1977).

the constitutionality of the latter where the foreign subsidiary is not functionally integrated with the parent and misattribution of income to the parent results and where the California method contradicts federal tax policy.

2. Container is a domestic corporation headquartered in Chicago, Illinois. During the relevant years (1963-1965), Container engaged in the production and distribution of paperboard and paperboard-based packaging in the United States. Container also owned controlling interests in twenty corporations located in Western Europe, Mexico, Colombia and Venezuela engaged in the same line of business. Stip. ¶ 26.[3] Container does business in California and filed a unitary franchise tax return including income from all its domestic operations.

The operations of the foreign subsidiaries were highly decentralized so that the subsidiaries located in each particular country operated as a fully integrated autonomous business rarely crossing the borders of their own country. Stip. ¶ 61. Personnel, including management of the foreign subsidiaries, were comprised almost exclusively of citizens of the countries involved. Stip. ¶ 74. In most of the Latin American subsidiaries, local investors held substantial minority stock interests. Stip. ¶ 25. The degree to which the foreign subsidiaries operated as independent businesses is illustrated by the following facts:

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[3]References are to paragraphs of the Stipulation of Facts ("Stip.") found in the Clerk's Transcript on Appeal ("C.T.") at 147-169 and 181-263. This case was presented to the trial court entirely on stipulated facts plus a single expert witness. Appellant will request that the record in the case be transmitted to the Court.

Flow of Goods. Container purchased no raw materials and no finished products from the foreign subsidiaries. Stip. ¶ 26. A small percentage of paperboard or raw material requirements of various subsidiaries was purchased at arm's-length prices by those subsidiaries from Container. Stip. ¶¶ 141, 143. In all cases the materials could have been obtained from other sources. Stip. ¶ 141.

Managerial Relationship. The management of the foreign subsidiaries had complete authority and control over business decisions. Stip. ¶ 74. The involvement of Container management in decisions affecting the foreign subsidiaries was limited to decisions about capital appropriations such as the expansion of a facility involving a major capital expenditure. Stip. ¶ 74.

Exchange of Technology. Beyond the initial efforts involved in establishing the foreign subsidiaries,[4] which occurred many years before the years in suit, Container provided its subsidiaries with little material assistance in developing paperboard and packaging technology which, in any event, is widely known throughout the industry. Stip. ¶¶ 76, 83, 85, 146. Pursuant to technical service agreements or more informal arrangements with Container, unless prohibited by local law, Container charged its foreign subsidiaries for all information provided under these agreements. Stip. ¶¶ 66, 144-146.

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[4]Approximately half of the subsidiaries were purchased as established, ongoing businesses.

Exchange of Personnel. The foreign subsidiaries operated independent personnel departments. The number of employees who transferred from Container to a foreign subsidiary were very few. During the period in question, only twenty-six former Container employees were working for foreign subsidiaries, compared with the approximately 13,400 persons employed by Container and the 6,800 persons employed by the foreign subsidiaries. Stip. ¶ 119.

Loans. The foreign subsidiaries generally obtained financing from local sources without involvement by Container. In certain instances, Container guaranteed those loans. Container made direct loans to the subsidiaries for less than one-third of their financing. Stip. ¶ 133.

Centralized Services. There were no substantial centralized services performed by the parent for the subsidiaries (or vice versa) such as a central personnel, purchasing, advertising, marketing or accounting department. Stip. ¶¶ 134-150.

3. During the tax years at issue, the income of Container excluding foreign subsidiaries was $25,362,000, $28,975,000, and $30,027,000. Over Container's objection, California insisted that the income of the foreign subsidiaries be included in Container's tax base, increasing the tax base to $36,158,000, $43,055,000 and $45,916,000, respectively.

4. Container commenced this refund action on April 8, 1974 in the Superior Court of the State of California for the City and County of San Francisco. The complaint was based upon, and incorporated, claims for refund previously filed by Container and denied by the California Franchise

Tax Board. The claims demanded refunds upon the ground that the state is prohibited from including these foreign subsidiaries in a unitary return with Container under the due process and foreign commerce clauses of the Constitution.[5] From the earliest stage of the proceedings Appellant has raised the constitutional claim that Section 25101 of California Revenue and Taxation Code, on its face and as applied to the instant facts, is repugnant to the foreign commerce and due process clauses of the Constitution. Both the Superior Court and the Court of Appeal specifically rejected each of the due process and foreign commerce clause claims (App. A, *infra*, A-17 to A-26; App. B, *infra*, A-31).

THE QUESTION PRESENTED IS SUBSTANTIAL

I

THE DECISION BELOW INCORRECTLY DECIDES IMPORTANT CONSTITUTIONAL QUESTIONS, NOT PREVIOUSLY DECIDED BY THIS COURT, WHICH ARE SQUARELY PRESENTED IN THIS CASE

This case squarely presents to the Court for the first time the Constitutional conflicts, including conflicts with federal tax policy, surrounding California's expansion of the unitary apportionment method to include the income of foreign subsidiaries not doing business in the United States in the tax base against which the State's income tax is measured.

Under its unitary apportionment method, California treated Container and its foreign subsidiaries as if all

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[5]The complaint and claims also raised issues of California law not relevant to this appeal.

companies were engaged in a single business earning one income which could be apportioned to California on the basis of a three factor formula comparing the property, payroll and sales in California with the total world-wide property, payroll and sales of CCA and its subsidiaries.

The correct method for use in this case is the arm's-length method *vis-a-vis* Container and its foreign subsidiaries wherein the income of the subsidiaries is determined independently of the parent and the adequacy of intercompany charges is determined by an arm's-length standard. This arm's-length method is used both by the United States and the principal trading nations of the world (including those countries in which the foreign subsidiaries operated) in dividing income between the affiliated corporations operating in different countries. The use by California of a world-wide unitary apportionment method results in a significant distortion of Container's taxable income, double taxation of the foreign income of Container's subsidiaries and creates serious conflicts with federal tax policy.

A. The Considerations Enunciated In Japan Line Apply to the Foreign Commerce Clause Issue In This Case and Require Use of the Arm's-Length Method

In *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), this Court emphasized the special considerations attendant to state taxation of foreign commerce (as compared to interstate commerce):

> When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations

> beyond those articulated in *Complete Auto,* come into play. The first is the enhanced risk of multiple taxation.
>
> • • •
>
> Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. 441 U.S. at 446-48.

In *Japan Line* both the Court's opinion and the brief of the United States as amicus curiae addressed the specific question of the validity of the apportioned county property tax as applied to the containers owned by Japanese shipping companies. Both the Court, and the United States in its brief, determined that the property tax was invalid because of the problems of multiple taxation and interference with federal uniformity, relying upon cases involving many types of state taxes including state income taxes. Both the Court and the United States left open the question of whether these additional considerations should apply equally to other state taxes when determining their validity under the commerce clause. The decision below construes *Japan Line* as limited to the property tax involved in that case. Appellant submits that both additional considerations apply equally to state corporate income taxes.

1. Double taxation results because the income of the foreign subsidiaries is taxed in their respective countries on an arm's-length basis, *i.e.*, the income earned by a particular subsidiary was taxed in its country of operation without reference to income of its domestic parent. Stip.

¶¶ 139-140. By contrast, California taxed the apportioned segment of the world-wide income, taking into account the same income (before foreign tax) of the foreign subsidiaries which has already been taxed in those foreign countries. This results in a double tax burden on income from foreign commerce to which domestic commerce is not exposed.

Double taxation can be illustrated by application of California's own apportionment formula. That is to say, if one applies the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being world-wide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by world-wide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:

1963	1964	1965
$2,407,000	$3,996,000	$5,466,000

This double taxation is confirmed by a comparison of the income attributed to the various countries under an arm's-length analysis with that assigned to the countries by the use of California's apportionment formula.[6]

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[6]This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal.3d 745, 754, 91 Cal.Rptr. 616, 621 (1970).

	Average Pre-Tax Income per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
CCA (United States)	$28,121	$32,068
Colombia	4,254	2,203
Mexico	1,605	1,430
Venezuela	4,246	1,907
Panama	1,286	—
Austria	(13)	11
Germany	1,793	2,906
Holland	384	197
Italy	34	968
Total Foreign	13,588	9,642
Total Combined	$41,710	$41,710

000's omitted—Sch. VI to Exh. 1, Stip. re Testimony, C.T. 289.

Multiple taxation is illustrated from the fact that the apportionment formula attributes to other countries approximately one-half of the income produced in Colombia and Venezuela according to arm's-length principles applied in those countries. In Colombia's case, for example, this produces the ludicrous result of apportioning about the same pretax *income* to Colombia as the Colombian subsidiaries paid in Colombian income *taxes*. The *income* attributed to Colombia by the California formula for the years in question is, respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be $2,508,036, $2,533,755, and $1,484,104, respectively.[7] This is a severe dislocation of the tax base.

[7]Second Addendum to Stip. ¶ 159, C.T. 147-149. As a further example, by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of $384,000 per year. The actual taxes paid to the Dutch government averaged 97 percent of the income attributed to Holland by the California formula. *Id.*

The decision below dismissed the consequences of multiple taxation as resulting merely "from the imposition of two different methods of calculation. . . ." App. A, *infra*, 24. That distinction is hardly persuasive. While different methods will inevitably lead to a certain unavoidable degree of multiple taxation, the California system is so severe a departure from the internationally customary method that the system guarantees severe and systematic dislocations. Furthermore, as in *Japan Line*, this case presents a situation "where true apportionment does not exist and cannot be policed by this Court at all." (441 U.S. at 455) Certainly this Court cannot require the sovereign countries involved here, any more than it could Japan, to change their apportionment systems.

2. The second additional consideration identified by the Court in *Japan Line* was the impairment of federal uniformity:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with

> one voice' in regulating foreign commerce. 441 at 450-51.

The application of those principles to this case is striking. California's novel world-wide unitary approach also creates an asymmetry in the international tax structure since the custom of nations has been to determine taxable income based on the arm's-length method. California, like Los Angeles County, has imposed a dramatically different method of determining taxable income upon the international community creating a climate where "international disputes over reconciling apportionment formulae may arise." 441 U.S. at 450. The "if other states followed . . ." language quoted above is particularly appropriate since other states have already followed California's lead. See page 25, *infra*.

In considering this aspect of *Japan Line* it is important to focus on the international tax structure and federal policies in regard thereto. In both federal legislation and tax treaties entered into with the principal trading countries of the world, the United States has developed clear policies based upon recognizing United States corporations and their subsidiaries operating in foreign countries as separate entities with separate incomes. California's unitary apportionment method, which starts from the total world-wide income of Container and its foreign subsidiaries, is in sharp contrast to such federal policies. Successive Assistant Secretaries of Treasury for Tax Policy testified at different times to Congress and commented on the effect of California's approach as follows:

> In this connection I would note that the arm's-length standard is the internationally accepted norm for

> apportioning income between related taxpayers. It is confusing to other countries and disconcerting to international relations when our states use a different standard.[8]
>
> The practice [of requiring a world-wide unitary report] has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.[9]

By apportioning Container's income on a combined, world-wide basis that includes the income of Container's foreign subsidiaries, California has employed a mode of taxation that is inconsistent with the well-established federal system for determining the amount of income arising within this country. Further, to the extent that the unitary method produces an amount of taxable income for the United States operations of Container which exceeds the amount determined on an arm's-length basis (which is true in Container's case for each of the years in issue), then necessarily California will be taxing foreign source income as that term has been defined and recognized for federal

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[8]Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines Before the S. Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (Statement of former Assistant Secretary of Treasury for Tax Policy, Laurence N. Woodworth) [hereinafter "Woodworth"].

[9]Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 3, 7 (1980) (Statement of Donald C. Lubick, former Assistant Secretary of Treasury for Tax Policy) [Hereinafter "Lubick"].

income tax purposes, as well as by other countries. Thus, the decision below is inconsistent with *Japan Line*.[19]

B. The Extension of Unitary Apportionment to Container and Its Foreign Subsidiaries Produces Such Misattribution of Foreign Source Income to California as to Violate the Due Process as Well as Foreign Commerce Clauses

There are no decisions of this Court which have considered the constitutionality of including in the tax base income of a foreign subsidiary (or parent) not engaged in business in the United States. Indeed, there are only two decisions of this Court in which, to our knowledge, income derived in a foreign country was taken into account in making an apportionment that was upheld over due process and commerce clause objections. Both are distinguishable. The first is *Bass, Ratcliff & Gretton Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), involving an English corporation, which brewed ale in England and sold it in the United States. Significantly, no question concerning a subsidiary was present because all operations were conducted

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[19]The error below is underscored by a recent decision of the United States District Court for the Northern District of California in which a British parent with a United States subsidiary challenged the application of California's unitary approach. Judge Renfrew dismissed the suit on procedural grounds but questioned the validity under *Japan Line* of California's unitary approach, as follows:

> ". . . the Court has substantial question as to the ultimate constitutionality of the California unitary tax being applied to foreign corporations with foreign subsidiaries, particularly in light of *Japan Lines*. . . ." *Capital Industries—EMI, Ltd. v. Bennett, et al.*, No. C-79-2145 (N.D. Cal. 1980), *appeal docketed*, No. 80-4114 (9th Cir. Mar. 13, 1980).

by a single corporate taxpayer. Moreover, the taxpayer adduced no proof of misattribution of income to New York, the taxing state. Instead, it rested its entire challenge to the constitutionality of the tax on the fact that the apportionment attributed net income to New York, whereas for federal income tax purposes, the company's domestic operations showed a loss. In contrast, the record in this case establishes the requisite factual basis for a determination that, as a result of the world-wide apportionment, there has been substantial misattribution of foreign source income of Container's subsidiaries to its California tax base.

The other Supreme Court decision in which foreign source income was included in an apportionment was the recent decision in *Mobil Oil Co. v. Vermont*, 445 U.S. 425 (1980) sustaining the power of a State to tax dividends declared by foreign subsidiaries to a domestic parent corporation. *Mobil* did not involve unitary combination. In this case, Container does not challenge the inclusion of dividends in the income of the domestic corporation. Rather, here the issue is the inclusion of the total income of the foreign subsidiaries. Although in *Mobil* the Court stated that the income of a business "operating in interstate [or foreign] commerce is not immune from a fairly apportioned state taxation," Mobil had "disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula". *Id.* at 434-36. *The dispute disclaimed by Mobil, however, is precisely the issue raised by Container, namely, that the California worldwide apportionment is inaccurate and unfair, both inherently and as applied to the facts of this case.*

The extension of apportionment to Container's operations in foreign countries results in substantial misattribution to California of income derived from foreign sources. This result may be expected in many cases. A widespread consensus has been reached among the states that the three factor formula is an acceptable and equitable method of dividing the taxable income of multistate enterprises among the states. The premise on which that consensus was forged is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized in one state, typically produced roughly the same amount of income as a dollar so spent or sales made in other states. However, when apportionment is extended to foreign countries the premise is no longer true. Hence, the attempted extension of the three factor formula beyond the borders of the United States produces an unreasonable result. The Court below failed to recognize this vital difference between operations within the domestic United States and operations that are extended to include foreign countries. The Court relied upon decisions involving operations within the United States, and upon *Mobil* and *Bass Ratcliff* which are distinguishable as pointed out above (App. A, *infra*, A-20).

Distortion is apparent from the record in this case. First, as described at pages 10-11, *supra*, formula apportionment when applied to the world-wide income of Container and affiliates attributes significantly more income to the domestic operations of Container than was determined for federal income tax purposes by applying the sophisticated accounting techniques prescribed by the Internal Revenue Service.

Second, there are significant differences in the wage rates of workers in countries other than the United States. Because wages are one of three factors used in formula apportionment, the formula inflates the profits apportioned to United States operations where wages are higher.[11] The studies noted below are confirmed by Container's own experience. Container's workers in California are paid 2½ times the amount paid to workers in Colombia to produce the same quantity of corrugated containers. Stip. re Testimony (Kucharvy) C.T. 269-91; Sch. II to Stip. C.T. 285; Reporter's Transcript at 58. [Hereinafter "R.T."]

Third, the formula leads to misattribution of income because of the significant differences in profitability be-

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[11]The major differences in the wage rates of United States workers and those of other countries are well known and widely discussed by spokesmen of industries facing increased competition from lower-priced imports. See table set out in App. H, A-41. These differences in wage rates are not offset by different levels of productivity of workers in various economic settings. *See* table set out in App. I, A-43. These studies are confirmed by other sources. As stated in Peterson, *California Franchise Tax: Combined Income Report Affects Foreign Companies,* 44 J. Tax. 184, 187 (1976):

> . . . wage levels are considerably lower in Japan, Italy or almost any other country than in the United States for the same work. In 1969, the cost of engineering work in Japan was only 70% of that in the U.S. (England was 75%, Holland 80%, France 90%). . . .
>
> The same type of disparity exists as to the cost of plant or property. For example, . . . in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U.S. was $137,000, while an average of only $58,000 was required outside the U.S.
>
> An apportionment of worldwide income based on property and payroll could never, under these circumstances, properly apportion the income to the local activities which produced it.

tween domestic and foreign operations. This is demonstrated by Container's own experience since the company sought a higher rate of return on its foreign investments (Stip. re Testimony (Green) C.T. 293) and its foreign subsidiaries were substantially more profitable than Container. See Schedules to Stip., V, VI and VII, C.T. 288-91, for a variety of methods demonstrating the higher rate of return from the foreign subsidiaries. The expert testimony of Professor McDonald of Stanford University (which was not disputed by the state) confirms that the foreign operations can be expected to be more profitable than the domestic operations, and that the California formula does not take these differences into account.[12] Multinational corporations expect a higher rate of return on a foreign investment than on a similar domestic investment and it is achieved even after accounting for all losses. Such higher return is required because of the much greater risks involved in foreign operations; it is achieved for several reasons including lower labor costs, rapidly expanding

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[12]The same conclusion was reached by Assistant Secretary Woodworth: "Moreover, the unitary apportionment system as a means for determining the state taxation base of a multinational corporation is highly imperfect and a poor substitute for the arm's-length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. *The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.*" Woodworth at 34. (Emphasis added).

economies, and a greater market share. R.T. 12-20, 21-23, 33-34. Furthermore, Professor McDonald testified that the differences in economic conditions between the United States and the rest of the world are not temporary or short-term in the way differences within the United States are. R.T. 45.

In *Norfolk & Western Railway v. Missouri State Tax Commission*, 390 U.S. 317 (1968) this Court, noting that the apportionment formula used by the State might be constitutional under other facts, concluded that it was unconstitutional as applied:

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most circumstances, may produce a tolerable product. *Id.* at 327.

The record in this case demonstrates that the formula leads to an unacceptable level of distortion so as to violate due process. In a similar circumstance the Court in *Norfolk* fashioned a burden of proof to meet the situation before it:

> We repeat that it is not necessary that a state demonstrate that its use of the mileage formula has resulted in an exact measurement of value. But when a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail. *Id.* at 329.

The record in this case establishes such "strong evidence." Since that evidence has been presented by Container and not rebutted by the State, the decision below is in error.

C. Due Process Requires that the Operations Treated as Part of the Unitary Business Must Be "Functionally Integrated" in a Substantial Manner Well Beyond What Exists in this Case

Even if the Court concluded that California's formula could be extended to include some foreign subsidiaries of a domestic corporation, it is clear from the prior decisions of this Court that there must be functional integration of the operations which are to be treated as unitary.

As the summary of facts above makes clear, the court below relied upon a series of trivial connections which are constitutionally insufficient to establish a unitary business.[13] Indeed, if the decision is allowed to stand, it is clear the test for a world-wide unitary business among

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[13]In the process the decision below ineffectively attempted to explain away the lack of the significant interrelationships which would have justified the decision. For example, the admittedly "low level of product exchange" was explained away because of the "nature of the business, high transportation costs and import restrictions" (App. A, *infra*, A-14); the independence of the subsidiaries in their "management, production and distribution" was explained by Container's organizational framework which "calls for decentralization even in its United States operations" (App. A, *infra*, A-14). The decision also relied heavily upon its erroneous characterization (App. A, *infra*, A-12) that "major policy decisions of the subsidiaries were subject to review by [Container]", failing to note the uncontroverted, stipulated facts that the management of the foreign subsidiaries had complete authority and control over business decisions and the involvement of Container management was limited to decisions about capital appropriations. Stip. ¶ 74.

affiliated corporations in the same line of business will have evolved to little more than that of common ownership. Lacking any substantial facts demonstrating functional integration, the court below relied on a presumption in the California regulations that "[a] taxpayer is generally engaged in a [unitary] business when all the activities are in the same general line." California Administrative Code, title 18, section 25120(b). (App. G. A-39). The record in this case amply establishes that there is no unitary business.

By contrast, all the decisions of this Court considering the nature of a unitary business have involved fact patterns where the functional integration, centralization of management, and economies of scale were apparent.[14] For example, in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 224 (1980) at 224 the Court noted "this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction." It is clear that the rationale for apportionment of *unitary* business income is lacking where foreign subsidiaries constitute *discrete* business enterprises. In *Butler Bros. v. McColgan*, 315 U.S. 501, 508-509, the taxpayer lost because it had not shown "that income unconnected with the unitary business ha[d] been used in the formula." Similarly, in *Bass, Ratcliff*, the company profits

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[14] *Bass, Ratcliff, Underwood Typewriter v. Chamberlain*, 254 U.S. 113 (1920), *Hans Rees', Sons Inc. v. North Carolina*, 283 U.S. 123 (1931), *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), and *Exxon* (all involving vertically integrated manufacturing and selling); *Butler Bros.* (centralized purchasing of inventory).

were seen to derive from "a series of transactions beginning with the manufacture in England and ending in sales in New York and other places . . . ," 266 U.S. at 282.

This case invites the Court to draw the constitutional line more precisely in the context of foreign subsidiaries which can be said *not* to "contribute" to a world-wide "enterprise." *Id.* at 435. The decision below rejected (App. A-12) the "bright line" standard Container urged upon the court, namely that there must be a substantial transfer of products. Other state courts, as well as the leading commentator, have concluded that flow of products must exist for a business to be unitary.[15] Whatever standard this Court adopts in this or subsequent cases it should not include the instant situation where there exists only ownership, an administrative presumption in the event of similar businesses and a limited number of insubstantial connections.[16]

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[15] *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Ash Grove Cement Co. v. Department of Revenue*, [1977 Transfer Binder] Or. T.R. (CCH) ¶ 203-221 (1977); Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat'l Tax J. 487, 501-502 (1968).

[16] "California tax authorities appear to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must be included in a combined report to the tax authorities." *Woodworth* at 32. *See also:* Hearings Before the Subcomm. on State Taxation of Interstate Commerce of the Comm. on Finance, 93rd Cong., 1st Sess. 433, 434 (1973). (Statement by John S. Nolan, former Deputy Assistant Secretary of Treasury for Tax Policy.)

II

THE DECISION BELOW PERMITS AND ENCOURAGES A CONTINUING AND SUBSTANTIAL DISCRIMINATORY TAX BURDEN ON MULTINATIONAL CORPORATIONS AFFECTING AMERICA'S FOREIGN COMMERCE AND CONFLICTS WITH WELL-ESTABLISHED FEDERAL POLICY

As described at pages 12-15 *supra*, a substantial conflict exists between federal policy for allocating and apportioning income of affiliated corporations between the United States and foreign countries (the arm's-length standard) and the California apportionment approach (the unitary method) at issue in this case. The arm's-length standard is also "the internationally accepted norm" for such apportionment.[17]

The California approach has already led to complaints from foreign governments, including the United Kingdom, France and Canada, lodged of course with the federal government.[18] It is apparent that it "affects international relations in a persistent and subtle way." *Zschernig v. Miller*, 389 U.S. 429, 440 (1968). As described at pages 13-14 *supra*, recent Assistant Secretaries of the Treasury for Tax Policy have testified to the confusion and irritation to other countries which the California approach creates.

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[17] *Woodworth*, at 33. See also Article 9(1) OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (1977).

[18] Opposition of a number of foreign governments is noted in *Lubick*, at 10.

This conflict between the federal system and the unitary system employed by California is not merely concerned with the State of California. At least six Western states, plus Illinois and recently New York (as to oil companies)[19] are presently following California's example. We understand that world-wide unitary tax bills are under consideration in Rhode Island, Minnesota, and Massachusetts. This Court should accept this case to determine if world-wide application of the unitary method as utilized by California and a growing number of other states conflicts with federal policy and adversely affects foreign commerce.

The impact on foreign commerce is evident. One of the key elements in the international economic policy of the United States is to encourage the free flow of capital and technology among the international community and to eliminate double taxation. To reduce or eliminate these impediments, the federal government has adopted a statutory scheme and entered into various bilateral treaties designed to promote free trade by harmonizing U.S. tax policy with that of our trading partners. As stated by former Assistant Treasury Secretary Edwin S. Cohen:

> We have at the present time some 20 income tax treaties with foreign countries and about a dozen estate tax treaties, and we consider that these are quite important for the purpose of preventing double taxation by two or more countries of income and estates, and

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[19]The bill (introduced as S. 7093 and A. 9057) was signed by the Governor, July 11, 1981.

by eliminating this double taxation we remove fiscal barriers to international trade and investment.[20]

It is precisely those fiscal barriers which California and other states are establishing. These barriers are not merely academic. The California administration has been told by Japanese industrialists that world-wide unitary tax requirements "were major obstacles to additional Japanese investment in California."[21] At hearings held by the California Assembly Revenue and Taxation Committee in 1979, representatives of several corporations testified that the application of the unitary approach worldwide kept them or others from locating certain facilities in California.[22]

Finally, the stakes are high. The amount of foreign exports from California has been estimated at $8 billion[23] in 1976. The California Franchise Tax Board estimates that it would have lost in 1974 approximately $125 million in franchise tax revenues if it were unable to continue apply-

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[20]Hearings on Tax Conventions with Belgium, Finland, Trinidad and Tobago, and The Netherlands, Before the S. Foreign Relations Committee, 91st Cong. 2d Sess., 2 (1970).

[21]Blankenship, *California's Unitary Tax System—Does It Make Sense*, Cal. CPA Q. 18, 19 (December 1978).

[22]Cal. Assembly Revenue and Taxation Comm., Bank and Corporation Tax, Vol. III, *Unitary Apportionment and World-Wide Combination*, Xerox (101-104); IBM (123-125); Eli Lilly & Co. (126-127); Lloyds Bank (39-40); B.A.T. Industries (47, 54); Rolls-Royce (60); testimony by representative of California's own Department of Economic and Business Development (57-63) (1979).

[23]U.S. Industry and Trade Administration, Dep't of Commerce, State Export Series, *California Exports* 3 (1978).

ing the unitary theory worldwide.[24] The former Assistant Secretary of Treasury for Tax Policy has suggested that such an estimate "may be an indication that unitary apportionment does, in fact, result in unjustifiable extra-territorial taxation."[25] Container agrees.

CONCLUSION

For these reasons, this Court should note probable jurisdiction of the appeal.

Dated: September 14, 1981

Respectfully submitted,

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[24]Calif. Assembly Revenue and Taxation Committee, Bank and Corporation Tax, Vol. V, *Unitary Method of Apportionment: A Second Look* 29 (1980).

[25]*Woodworth* at 34.

Appendix A

In the Court of Appeal
of the
State of California

First Appellate District

Division Four

1/Civil 48990
(Superior Ct. No. 673-492)

Certified for Publication

Container Corporation of America,
Plaintiff and Appellant,

vs.

Franchise Tax Board,
Defendant and Respondent.

[Filed April 14, 1981]

Container Corporation of America appeals from a judgment denying partial refund of corporation franchise taxes paid for the income years 1963, 1964 and 1965. We affirm the judgment.

The question is whether, under stipulated facts, appellant was properly treated as deriving income from sources both within and outside California (Rev. & Tax. Code, § 25101)[1] on the basis that appellant and its foreign subsidiaries constituted a unitary enterprise.

[1]Revenue and Taxation Code section 25101 for the period in question provided in part: "When the income of a taxpayer subject

Appellant, a Delaware corporation headquartered in Chicago, is engaged in the production and distribution of paperboard packaging materials. Appellant is subject to corporation franchise taxes on its activities in California. During the disputed tax years, appellant controlled 20 subsidiaries in Western Europe and Latin America. All these subsidiaries except one were engaged in the paperboard packaging business.

Appellant has assigned responsibility for its United States operations to regional vice-presidents, each responsible for corporate operations in his area. This same policy of decentralization was followed in setting up the foreign subsidiaries. Appellant's first foreign operation was established in Colombia in 1944. The Colombian group directed legal work, selected and trained personnel, and promoted local sales; the parent corporation managed the technical and financial aspects of the business and supplied some equipment and raw materials. All the foreign subsidiaries were managed predominantly by local citizens. Self-reliance by the subsidiaries was encouraged.

During the years in question, 38 of appellant's approximately 13,400 employees were assigned to foreign sub-

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to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. . . . Income attributable to isolated or occasional transactions in states or countries in which the taxpayer is not doing business shall be allocated to the state in which the taxpayer has its principal place of business or commercial domicile." (Stats. 1957, c. 2097, § 1, p. 3721.)

sidiaries; some other employees of appellant were transferred to foreign subsidiaries and were no longer on appellant's payroll. Appellant had no special aim of transferring employees to the foreign subsidiaries. Such transfers generally responded to a specific need of a subsidiary. If the subsidiary requested assistance from appellant in finding a person with particular qualifications, appellant might suggest one of its own employees. Employees transferred to foreign subsidiaries usually continued to draw some pay from appellant, and fringe benefits except participation in appellant's stock bonus plan were continued even after transfer. Language and cultural differences, and a perceived need to present an acceptable local image, did substantially inhibit transfer of employees from the parent corporation to the foreign subsidiaries.

Only three of appellant's executives dealt regularly with the foreign subsidiaries. Local employees were in day-to-day control, but all important moves of the subsidiaries were subject to review by appellant's management. Appellant and its foreign subsidiaries usually reached decisions by mutual consent, but appellant held local management responsible for the performance of foreign subsidiaries. Appellant was represented on the board of directors of most of the subsidiaries.

There was no regular program for training in the United States of employees of foreign subsidiaries. But 10 or 12 times a year a foreign employee came to the United States for several weeks to learn appellant's operations. The foreign subsidiaries paid the cost of these visits.

Appellant made loans to its subsidiaries totaling $7,704,987, $7,155,714 and $3,223,371, for the three disputed years. The subsidiaries also borrowed from local sources; appellant guaranteed approximately one-third of these loans.

The foreign subsidiaries' budgets were regularly sent to appellant for its information but specific approval was not required. Current financial data were furnished to appellant each month. The foreign subsidiaries provided appellant with a more detailed financial statement at the end of each year. Although appellant's management thus kept informed of operations of the foreign subsidiaries, most financial decisions were made by the management of the individual companies.

All the foreign subsidiaries except those in the Netherlands and Germany were audited by the accounting firm which appellant used for its own audits. On the other hand, tax returns to foreign governments were locally prepared. These returns reported only the revenue produced and costs incurred by the subsidiary in the taxing jurisdiction. Each subsidiary used local law firms.

Appellant purchased no raw materials or finished products from its subsidiaries and did not engage in joint marketing efforts with them. Appellant sold paperboard and raw materials in small amounts to the foreign subsidiaries; those materials could have been obtained from other sources. Appellant also purchased paper products from outside parties, for the benefit of the foreign subsidiaries. Appellant entered into technical service agreements with some subsidiaries and provided such services for other subsidi-

aries under informal arrangements. Appellant did not cooperate so extensively with any nonaffiliated companies.

Occasionally, appellant assisted subsidiaries in the acquisition of equipment and machinery. Some of the equipment was purchased directly from appellant. Appellant also sometimes acted as a sales broker for the foreign subsidiaries. Although this function could have been performed by independent brokers, the commissions charged by the latter would probably be higher than the charge appellant made for the same services.

Appellant contends that its California and out-of-state operations do not comprise a unitary enterprise to which respondent board may properly apply its formula for apportionment of income. Constitutional principles prohibit taxation in the absence of a link between the property to be taxed and the taxing entity. (See *Mobil Oil Corp. v. Commissioner of Taxes* (1980) 445 U.S. 425, 436-437; *Miller Bros. Co. v. Maryland* (1954) 347 U.S. 340, 344-345.) Appellant maintains that the "unitary method of ownership, use and operation of the business of the parent and its subsidiaries" was not established here. (See *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 482.)

Because the parties submitted the case to the trial court on a stipulation, the case presents no conflicting evidence. Therefore, this court is not constrained by the substantial evidence rule. The trial court's findings are not binding on us and we must make our own determination of the questions of law presented by the stipulated facts. (*Rice Growers' Association of California v. County of Yolo* (1971) 17 Cal.App.3d 227, 230, cert. den. 404 U.S. 941; *Dealers In-*

stallation Service, Inc. v. State Bd. of Equal. (1970) 13 Cal.App.3d 395, 399; *Chase Brass & Copper Co. v. Franchise Tax Bd.* (1970) 10 Cal.App.3d 496, 502, cert. den. 400 U.S. 961; *Standard Register Co. v. Franchise Tax Board* (1968) 259 Cal.App.2d 125, 129-130.)

A corporate taxpayer's income must be subjected to apportionment[2] when it "is derived from or attributable to sources both within and without the State." (Rev. & Tax. Code, § 25101, set out in fn. 1, *ante; Honolulu Oil Corp. v. Franchise Tax Bd.* (1963) 60 Cal.2d 417, 425; *Superior Oil Co. v. Franchise Tax Bd.* (1963) 60 Cal.2d 406, 417.) "[T]he linchpin of apportionability in the field of state income taxation is a unitary-business principle." (*Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. 425, 439.) The fairness of allocating to California a just proportion of the profits earned from a unitary business[3] is settled. (See

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[2]The California method of apportionment is explained in Keesling and Warren, *The Unitary Concept in the Allocation of Income* (1960) 12 Hastings L.J. 42, 43: "Under the formula method the business activities within the state are considered to be an inseparable part of a business carried on both within and without the state. The total gross income from the entire business is determined. The allowable deductions are then subtracted and the remaining net income is apportioned within and without the state by means of an allocation formula consisting of various factors which are thought to be relevant in the production of income, such as property, payroll, and sales."

[3]Keesling and Warren also discuss the unitary treatment of multicorporate enterprises (*op. cit. supra,* 12 Hastings Law Journal 42, 57): "In any case where a business would be considered unitary if conducted by one taxpayer, it should likewise be so considered even though conducted by two or more affiliated corporations. Just as a state may look beyond its borders and take into account the entire income of a business in arriving at a determination of the amount of income reasonably attributable to the activities con-

Butler Bros. v. McColgan (1942) 315 U.S. 501, 509; *El Dorado Oil Works v. McColgan* (1950) 34 Cal.2d 731, 738, app. dism., 340 U.S. 801; *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 478; *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 677-678, aff'd in 315 U.S. 501; *Handlery v. Franchise Tax Bd., supra,* 26 Cal.App.3d 970, 974.)

The propriety of applying the unitary concept in taxing foreign corporations was established in *Butler Bros. v. McColgan, supra,* 17 Cal.2d 664. The court there noted that only in circumstances where the corporation's California business is "truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used." (*Id.,* at pp. 667-668.) The court set out a three-part test to determine the unitary nature of a taxpayer's business: "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, accounting and management divisions; and (3) unity of

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ducted within the state, so in the case of a group of affiliated corporations engaged in the conduct of a business, it may look at the total income of the group to determine the amount of income attributable to the portion of the business conducted within the state by one or more of the members of the group."

The fairness of the formula apportionment method is explained as follows: "[T]he 'formula' apportionment of unitary business income has not only been found to be constitutionally permissible, but . . . it is often the only reasonable and practical manner in which a state may levy and collect taxes to which it is constitutionally entitled. It might be described as a sort of rule of necessity, having its origin in the accommodation of a state's constitutional right to tax income derived from within the state, to constitutional due process of law and interstate commerce provisions." (*Handlery v. Franchise Tax Bd.* (1972) 26 Cal.App.3d 970, 974.)

use in its centralized executive force and general system of operation." (*Id.*, at p. 678; see *Honolulu Oil Corp. v. Franchise Tax Bd., supra,* 60 Cal.2d 417, 423; *Superior Oil Co. v. Franchise Tax Bd., supra,* 60 Cal.2d 406, 412; *John Deere Plow Co. v. Franchise Tax Bd.* (1951) 38 Cal.2d 214, 229, app. dism., 343 U.S. 939; *Edison California Stores v. McColgan, supra,* 30 Cal.2d 472, 478; *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 502; *Standard Register Co. v. Franchise Tax Board, supra,* 259 Cal.App.2d 125, 129.)

The first element, unity of ownership, is present here: the parent corporation owned the foreign subsidiaries. However, unity of ownership does not render a business unitary if the other two requirements are not met. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 502.)

Unity of operation and unity of use are concepts that may to some degree overlap, but generally functions that in administrative theory are labeled "staff" fall within the "operation" category and "line" functions fall within the "use" category. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 502.) Determining the presence of unity between the parent corporation and the foreign subsidiaries in the area of operations is guided by various factors; no one element controls the decision.

Although appellant bought no raw materials or finished products from its subsidiaries, appellant did sometimes sell small quantities of paperboard and raw materials to its subsidiaries. The subsidiaries could have obtained those materials from other sources at the same price appellant

charged, but the access to materials stocked by the parent is of some relevance. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 503.)

Appellant sold some of its used equipment to its subsidiaries during the period in question. Appellant also assisted its subsidiaries in the acquisition of equipment and machinery. Appellant sometimes contacted a subsidiary when considering disposition of a piece of equipment in good operating order that might assist in the subsidiary's operation.

Appellant assisted its subsidiaries in procuring paper, personnel and equipment. Appellant purchased some paper from third parties in order to convey such goods to its foreign subsidiaries. If a subsidiary was unable to fill an important vacancy, it would request assistance from appellant in locating an individual with the proper qualifications. Appellant generally looked within its own ranks for such a person. Appellant's purchasing department played a part in procuring equipment from independent suppliers for the benefit of its subsidiaries. These purchasing and brokerage ties between parent and subsidiary are of some relevance. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 503.)

Although appellant and all but two of its foreign subsidiaries kept separate books of account, all the foreign operations were audited by the same accounting firm that audited appellant's books. A format developed by appellant for the transmission of monthly and quarterly financial reports was used by the subsidiaries.

Appellant loaned to its subsidiaries over $18,000,000 during the period in question. Appellant also guaranteed approximately one-third of the subsidiaries' other loans. Although the subsidiaries may have been able to obtain credit from other sources, the loans serve as "substantial evidence of unity of operation." (*Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 503.) The fact that the subsidiaries could readily turn to appellant for financial assistances points toward unity. (*Id.*) So does the foreign subsidiaries' ability to utilize appellant as a guarantor of its loans. "It must have been deemed advantageous to the over-all management to have handled the transaction in this way, otherwise a separate arrangement would have been made." (*Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 503.)

Although there were no common employee benefit plans, some employees of the subsidiaries remained on appellant's payroll. Employees of appellant who transferred to the foreign subsidiaries were allowed to continue their employee benefits, and seven such employees were given options to purchase appellant's stock.

There was considerable interplay between appellant and its foreign subsidiaries in the area of corporate expansion. Although there was no continued effort by appellant to solicit business for its foreign subsidiaries, on at least one occasion appellant assisted in the negotiation of a contract for a foreign subsidiary.

The third element, unity of use, relates to executive forces and operational systems. (*Superior Oil Co. v. Franchise Tax Bd., supra,* 60 Cal.2d 406, 415; *Chase Brass &*

Copper Co. v. Franchise Tax Bd., supra, 10 Cal.App.3d 496, 504.) Appellant contends that the absence of a steady flow of raw materials and manufactured goods between the parent corporation and its subsidiaries compels a conclusion that unity of use is lacking. But the California Supreme Court has twice held an operation to be unitary though there was no substantial flow of goods between corporate entities. (See *Honolulu Oil Corp. v. Franchise Tax Bd., supra,* 60 Cal.2d 417; *Superior Oil Co. v. Franchise Tax Bd., supra,* 60 Cal.2d 406.) In *Superior Oil, supra,* the Supreme Court declared that "[n]one of the three unities . . . necessarily require the interstate movement of products." (*Id.*, at p. 415.) In *Honolulu Oil, supra,* the court rejected a contention that control by central management and centralized performance of service functions are insufficient alone to support a conclusion of a unitary operation(*id.*, at p. 423), and determined that "the mere fact that production and sale . . . are a local operation does not transform that operation to something distinct and apart." (*Id.*, at p. 424.)

Citing *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, appellant argues that *Honolulu Oil* and *Superior Oil* are not applicable outside the special facts presented in those cases. In *Chase Brass* this court held that a California subsidiary was not unitary with that part of its parent's operation which dealt with materials not being purchased by the subsidiary. (*Id.*, at p. 506.) But the decision does not depart from the earlier and binding holdings in *Honolulu Oil* and *Superior Oil, supra.* The ties which existed between the parent and subsidiary in areas beyond the subsidiary's normal business activities appear

to have been too tenuous to be given weight. Furthermore, the court noted that "[t]he fact of the sales alone . . . does not determine the business to be unitary." (*Id.*, at p. 506.) Appellant's contention that a substantial flow of goods is essential to the existence of a unitary manufacturing or mercantile business must be rejected. Product flow is important but it is only one of several factors to be evaluated in determining whether a business is unitary.

Appellant complains that the imposition of the unitary apportionment system severely misallocates to California, income from foreign sources. Appellant suggests that to avoid such a result substantial flow of goods between the parent and the subsidiary should be prerequisite to a determination of unitary status. But the adoption of a different formula than the one presently in effect is a legislative matter.

Because a substantial flow of goods between the parent and its subsidiaries is not requisite to unitary status, the operational interrelationship of the corporate entities must be evaluated. The integration of major executive functions is a factor of great importance pointing toward unity. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 504.) Although the everyday operations of the subsidiaries were handled by local employees, major policy decisions of the subsidiaries were subject to review by appellant. "The 'major policy matters' are what count in our estimation of integration." (*Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 504.) High officials of appellant gave directions to subsidiaries for compliance with the parent's standard of professional-

ism, profitability and ethical practices. Appellant constantly reviewed the financial reports of its subsidiaries; if these reports had not given sufficient information of a subsidiary's condition, appellant would have intervened. The submission of financial reports on a monthly basis from the subsidiary to the parent corporation is of some significance. (See *Standard Register Co. v. Franchise Tax Board, supra,* 259 Cal.App.2d 125, 136.) Appellant's officials served on the boards of directors of most of the subsidiaries. Thus, control on the highest level was exerted by appellant. Appellant also employed a "foreign operations staff" to oversee the subsidiaries, to prepare studies regarding the subsidiaries' activities and to give directions to the management of the subsidiaries.

Appellant's policy of regional decentralization was followed by the subsidiaries. The parent corporation was involved with the training of local nationals for management positions. Appellant provided important personnel, equipment and financing to assist its first foreign subsidiary to enter the paperboard packaging industry. Such assistance in the initial stages of operation was crucial to the success of the subsidiary. Appellant continued to provide technical assistance to its subsidiaries. The subsidiaries had ready access to appellant's expertise. The subsidiaries were only charged costs and an apportionment of overhead; in some cases the charges were not recovered. The extent of the technical assistance provided by appellant was substantial; it included design work, sample packaging, marketing research, formula methods used in packaging and cost accounting. Appellant did not provide extensive technical service to any nonaffiliated corporations.

The subsidiaries were prohibited from transferring information received from appellant to third parties.

The consolidation of the domestic and overseas operations extended to a public image of unity; in its 1963 annual report, appellant referred to the employees of subsidiaries as its own employees.

Appellant argues that the foreign subsidiaries are independent in their management, production, and distribution. But appellant's organizational framework calls for decentralization even in its United States operations. The relationship between parent and subsidiary comports with appellant's general philosophy of local management and a reliance on key executives to meet corporate goals. Appellant emphasizes the lack of product flow between the parent and the subsidiaries. But the low level of product exchange must be considered in conjunction with the nature of the business, high transportation costs and import restrictions. All but the latter consideration apply to appellant's United States operations. The desirability of creating an image of a locally operated enterprise is evident. The court in *Standard Register Co. v. Franchise Tax Board, supra,* 259 Cal.App.2d 125, recognized this tendency. "At all times Pacific division attempted to create the image of its being a California manufacturer in order to compete in the western market which was very conscious of buying western." (*Id.*, at p. 132.) The characterization by the parent corporation of its subsidiary as an independent entity does not compel a finding that several divisions of a corporation are nonunitary. Here, as in *Standard Register,* a study of the operations of appellant and its subsidiaries shows areas where the subsidiaries acted indepen-

dently of appellant. But there are other areas in which the parent and subsidiaries contributed to each oth[illegible] in unity of use and unity of operation. (See *Standard Register Co. v. Franchise Tax Board, supra,* 259 Cal.App.2d 125, 134-135.) Appellant's own view of its operations as a unitary business is evidenced by statements in the company's annual reports. Appellant identifies itself as "the world's largest producer of paperboard packaging," referring to overseas and domestic operations. Appellant also discussed in its reports the strategic location of packaging, printing and fabricating facilities both in the United States and abroad. Appellant stated that "[t]he overseas operations of CCA continue to grow and to become a more substantial part of the company's strength and profitability." Appellant further projected the image of unity by referring to its subsidiaries as overseas operations or overseas divisions. Appellant's self-image is relevant. (See *Standard Register Co. v. Franchise Tax Board, supra,* 259 Cal.App. 2d 125, 135.)

The three unities are satisfied here. Although some elements which normally exist in a unitary operation, e.g., a substantial flow of goods, are lacking, the combination of all the factors and ties between the parent and the subsidiary support respondent board's determination that the operation is unitary. Appellant engaged in the same business activities as its subsidiaries. The administrative regulations indicate that a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business.[4] This administrative construction of the Cali-

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[4]California Administrative Code, title 18, section 25120, subdivision (b), provides in part: "The determination of whether the

fornia tax laws "is entitled to great weight, and the courts generally will not depart from construction unless it is clearly erroneous or unauthorized." (*Coca Cola Co. v. State Bd. of Equalization* (1945) 25 Cal.2d 918, 921; also see *Select Base Materials v. Board of Equal.* (1959) 51 Cal.2d 640, 647; *Albright v. State of California* (1979) 101 Cal. App.3d 14, 18; *Cal. Correctional Officers' Assn. v. Board of Administration* (1978) 76 Cal.App.3d 786, 793-794; *Clayton v. County of Los Angeles* (1972) 26 Cal.App.3d 390, 396.) The interchange between parent and subsidiaries in the areas of technical assistance, development and management policymaking, is significant.

The portion of appellant's business done within the State of California is dependent upon or contributes to the operation of the business outside the state. (*Superior Oil Co. v. Franchise Tax Bd., supra,* 60 Cal.2d 406, 412; *Edison California Stores v. McColgan, supra,* 30 Cal.2d 472, 481; *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 501.) Although in many respects the

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activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts of each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the divisions under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business; and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

"(1) *Same type of business:* A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business."

foreign subsidiaries acted independently, the financing, general direction and control of the subsidiaries were in the hands of appellant. The subsidiaries were treated as overseas divisions of the parent corporation, bringing appellant's entire operation within the provisions of section 25101 of the Revenue and Taxation Code and requiring application of the formula apportionment method in determining the California taxes due from appellant.

Appellant contends that the inclusion of its foreign subsidiaries in the apportionment base violates the California taxation statute as well as the due process clause. But *Superior Oil Co. v. Franchise Tax Bd., supra,* 60 Cal.2d 406, *Honolulu Oil Corp. v. Franchise Tax Bd., supra,* 60 Cal.2d 417, *John Deere Plow Co. v. Franchise Tax Board, supra,* 38 Cal.2d 214, and *Max Factor & Co. v. Franchise Tax Bd.* (1973) 35 Cal.App.3d 7, contradict appellant's argument. The court in *Max Factor, supra,* noted that "Appellant (Taxpayer) is a Delaware corporation doing business in California. In the years in question, it had three subsidiary corporations operating in foreign countries. . . . In determining the measure of California franchise tax, Taxpayer and its subsidiaries were properly treated as 'engaged in a single unitary business.' (See Rev. & Tax. Code, §§ 25101, 25102; *Edison California Stores v. McColgan,* 30 Cal.2d 472, 479-480.)" (*Id.,* at p. 9.) Appellant relies on *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, as indicating that foreign subsidiaries should not be included in the apportionment base. Appellant states that "it seems fair to assume that the fact Braden was operating in a foreign country, as are the foreign subsidiaries in this case, was an important factor

in the court's determination." The assumption is unwarranted. Although the operations of Braden Company were excluded, so were those of Bear Creek Company, a United States operation. (*Id.*, at p. 506.) The court in *Chase Brass* distinguished between vertical and horizontal relationships. (See *Chase Brass & Copper Co. v. Franchise Tax Bd., supra,* 10 Cal.App.3d 496, 502.) The taxpayer in *Chase* was a California subsidiary of a United States parent corporation which also had other subsidiaries. Here, the taxpayer is the parent corporation; the vertical ties between parent and subsidiary are stronger than horizontal ties between sibling subsidiaries.

The due process challenge to the inclusion of foreign subsidiaries in the apportionment base of a state's taxation formula was rejected by the United States Supreme Court in *Bass, etc., Ltd. v. Tax Comm.* (1924) 266 U.S. 271. The court held that "[i]f the entire business of the corporation is not transacted within the State, the tax is to be based upon the portion of such ascertained net income determined by the proportion which the aggregate value of specified classes of the assets of the corporation within the State bears to the aggregate value of all such classes of assets wherever located." (*Id.*, at pp. 277-278.) The apportionment method was approved because the state meant to reach and in fact did reach only the profits earned within the state. Here, too, the California apportionment method is designed to reach profits earned within the state by combining all of appellant's unitary operations. The Supreme Court reiterated its basic premise in *Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. 425. The taxpayer in *Mobil Oil* did not argue that the state's

worldwide apportionment was inaccurate and unfair but asserted that foreign source income was subject to different tests. The Supreme Court in *Mobil Oil* stressed the importance of the unitary business principle as a justification for inclusion of foreign source income in a state's apportionment base. (*Id.*, at p. 438.) The Supreme Court noted the connection between due process requirements and the determination that a business is unitary: "Where the business activities of the . . . [subsidiaries] have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. . . . Mobil has failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates that would raise the question of nonapportionability." (*Id.*, at p. 442.)

Due process demands that a minimal connection exist between the out-of-state activities and the taxing state and a rational relationship between income attributed to the out-of-state and the intrastate values of the enterprise. The tax may not be disproportionate to the business transacted by appellant in the taxing state. (*Exxon Corp. v. Wisconsin Dept. of Revenue* (1980) 447 U.S. 207, 219-220; *Hans Rees' Sons v. N. Carolina* (1931) 283 U.S. 123, 135.) A sufficient nexus is established if the corporation "avails itself of the 'substantial privilege of carrying on business' within the state; . . ." (*Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. 425, 437; also see *Exxon Corp. v. Wisconsin Dept. of Revenue, supra,* 447 U.S. 207, 220.)

Appellant asserts that the application of the apportionment formula to foreign subsidiaries fails to account for different wages, property costs and returns on sales. Appellant recognizes that there are variations in wages, property costs and returns on sales within the United States, but argues that the wholly different nature of the elements in foreign countries creates an unreasonable result. Variations in profitability within the United States have not precluded apportionment of income according to an appropriate formula. (See *John Deere Plow Co. v. Franchise Tax Bd., supra*, 38 Cal.2d 214, 224-225.) Where a company is engaged in a unitary business, a state may apply an apportionment formula to the taxpayer's total income to arrive at a rough approximation of the corporate income attributable to activities within the state. (*Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, 447 U.S. 207, 223; *Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267, 273.) There is no necessity for a substantial flow of goods between the parent and the subsidiary corporation. Although appellant may treat its foreign operations as independent, the business activities of the subsidiaries benefit substantially from "an umbrella of centralized management and controlled interaction." (*Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, 447 U.S. 207, 224.)

Appellant points out that for its own purposes income derived from appellant's United States operations is separately accounted for. But a taxpayer's internal accounting methods are not binding on the taxing authorities. (*Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, 447 U.S. 207, 224; see *Butler Bros. v. McColgan, supra*, 315 U.S. 501, 507-508.)

Appellant points to each of the factors used in the formula apportionment in California—wages, property and sales—and emphasizes the major differences between wage rates in the United States and those in other countries. Appellant asserts that this wage differential is not offset by a higher level of productivity. But such variations in wages also exist in the United States, and do not preclude unitary treatment.

Respondent may constitutionally apply its apportionment formula to appellant's total income in order to establish tax liability. Appellant had the "distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed." (*Butler Bros. v. McColgan, supra,* 315 U.S. 501, 507; *N. & W. Ry. Co. v. No. Carolina* (1936) 297 U.S 682, 688.) Appellant's accounting evidence does not meet that burden. The fairness of applying the formula apportionment method must be evaluated in practical terms. A state's attempt to impose an accounting method in order to determine its proper share of the burden of taxation is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." (*Underwood T'Writer Co. v. Chamberlain* (1920) 254 U.S. 113, 121; also see *Exxon Corp. v. Wisconsin Dept. of Revenue, supra,* 447 U.S. 207, 224.) California's apportionment is not so burdensome as to violate due process.

Appellant urges that its statistical evidence shows that the application of the apportionment formula yields a distorted result. The United States Supreme Court in *Norfolk & W. R. Co. v. Tax Comm'n.* (1968) 390 U.S. 317,

329, held that "when a taxpayer comes forward with strong evidence tending to prove that the . . . formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if . . . the taxpayer has . . . show[n] that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail." The evidence appellant presented with respect to the disproportionality of income allocation is not compelling. It fails to account for contributions to income which result from the functional integration and centralization of management which exist in a unitary operation. It is "misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." (*Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. 425, 438; also see *Exxon Corp. v. Wisconsin Dept. of Revenue, supra,* 447 U.S. 207, 222-223.)

Appellant contends, citing *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434, that inclusion of its foreign subsidiaries in the apportionment formula is an unconstitutional burden on foreign commerce. But the question presented in *Japan Line* was "whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." (*Id.*, at p. 444.) The court did not reach questions as to "taxability of foreign-owned instrumentalities engaged in interstate commerce, or of

domestically owned instrumentalities engaged in foreign commerce." (*Id.*, at p. 444, fn. 7.) The Supreme Court distinguished situations involving a lack of apportionment from those challenging the mathematical imprecision of an apportionment formula. *Japan Line* involved a situation "where true apportionment does not exist and cannot be policed by this Court at all." (*Id.*, at p. 455.) Thus, *Japan Line* does not affect the present case.

The Constitution of the United States (art. I, § 8) provides that "Congress shall have power . . . 3. To regulate commerce with foreign nations, and among the several states, and with the Indian tribes." Generally, if the state tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," there is no impermissible burden on interstate commerce. (*Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, 279.) But when a state seeks to tax instrumentalities of foreign commerce, two additional considerations are involved. The first is the enhanced risk of multiple taxation. The second is that state tax on instrumentalities of foreign commerce may impede federal uniformity in an area where such uniformity is essential. (*Japan Line Ltd. v. County of Los Angeles, supra,* 441 U.S. 434, 446-448.) "Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce ' " 'to the risk of a double tax burden to which [domestic] commerce is not exposed and which the

commerce clause forbids.'"' *Evco v. Jones*, 409 U.S., at 94, quoting *J. D. Adams Mfg. Co.*, 304 U.S., at 311." (*Japan Line, Ltd. v. County of Los Angeles, supra*, 441 U.S. 434, 447-448.) Appellant's multiple taxation claim rests predominantly on the conflict between the California apportionment system and a separate accounting method. The variations which result from the imposition of two different methods of calculation do not necessarily violate the commerce clause. The Supreme Court has consistently held that the commerce clause "does not call for mathematical exactness nor for the rigid application of a particular formula; only if the resulting valuation is palpably excessive will it be set aside." (*Northwest Airlines v. Minnesota* (1944) 322 U.S. 292, 325 [Stone, C.J., dissenting], quoted in *Japan Line, Ltd. v. County of Los Angeles, supra*, 441 U.S. 434, 455.)

The totally international character of the corporate taxpayer in *Japan Line* is distinguished from the present situation where a United States parent corporation attempts to sever ties with its foreign subsidiaries for purposes of state taxation. The taxes levied by California are against appellant, a United States corporation doing business in the State of California, as opposed to a tax upon the foreign subsidiaries. The normal variations entailed in the use of different accounting formulas do not create such multiple taxation problems as to require its prohibition here. Further, the tax imposed in *Japan Line* was on instrumentalities of foreign commerce. By contrast, the tax imposed here is on total corporate operations; there is no curb on the free flow of commerce.

The unilateral act of one state may not be permitted to impede the conduct of United States foreign relations and foreign trade.[5] Appellant argues that the California approach could lead to retaliation and the imposition of a heavier tax burden by other states. Appellant underscores the differences between the federal tax scheme and the California formula apportionment method. Appellant insists that use of the federal separate accounting methods would simplify and standardize the worldwide approach to taxation. Adoption of the federal approach would purportedly reduce or eliminate impediments to the flow of capital and technology between the nations. But federal legislation requiring a uniform method for state taxation has never been adopted. (See *Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. 425, 449.) The California statutory scheme here adopted does not impermissibly

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[5]Examples of ways in which state government formulas may impede federal uniformity are provided in *Japan Line Ltd. v. County of Los Angeles, supra,* 441 U.S. 434, 450-451: "A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce."

burden international commerce. Appellant, the parent corporation, is engaged in a unitary operation with its foreign subsidiaries. Thus, the total corporate operations are subject to California's apportionment formula.

The judgment is affirmed.

Certified for publication.

Christian, J.

We concur:

Caldecott, P. J.

Poche, J.

[The judgment of the Court of Appeal is set forth in the final paragraph of its opinion and is not separately entered in the records of the Court.]

Appendix B

California Superior Court
City and County of San Francisco

No. 673-492

Container Corporation of America,
Plaintiff,

vs.

Franchise Tax Board,
Defendant.

[Filed Sept. 14, 1979]

NOTICE OF INTENDED DECISION

The above-entitled matter having come on for trial and evidence having been introduced by stipulation and through testimony, and the matter having been briefed and argued, was submitted to the Court on June 30, 1979. The Court renders herein its decision pursuant to Rule of Court 232.

The action involves a suit for refund of franchise taxes paid by plaintiff Container Corporation of America (hereinafter referred to as CCA) under the Bank and Corporation Tax Laws for the income years 1963, 1964 and 1965.

The issues are whether plaintiff (CCA) and its foreign subsidiaries engaged in a unitary business and therefore subject to formula apportionment under Revenue and Taxation Code § 25101; and (2) if so, does the fact that plaintiff CCA's subsidiaries were located outside the United States render invalid the application of formula apportionment?

I.

The Court finds that CCA and its foreign subsidiaries were engaged in a unitary business and are therefore subject to formula apportionment under Revenue and Taxation Code Section 25101. The unitary nature of a business is established by (1) unity of ownership, (2) unity of operation, and (3) unity of use. *Butler Brothers v. McColgan,* 17 Cal. 2d 664 (1941), aff'd. 315 U.S. 501 (1942).

CCA owned a controlling interest in its foreign subsidiaries. (*Stipulation of Facts, Para.* 10 and 25).

Unity of operation may be shown by central purchasing, advertising, accounting and management divisions. *Butler Brothers v. McColgan, supra.* It may also be shown by a common legal staff, a common retirement plan and financing services provided by one component of the business to another. *Chase Brass & Copper Co. v. Franchise Tax Board,* 10 Cal. App. 3d 496. If one of the above is not a factor in the taxpayer's business, its absence does not prevent a finding of unity of operation. *Honolulu Oil Corp. v. Franchise Tax Board,* 60 Cal. 2d 417.

CCA sold fibreboard, other paperboard and raw materials to the foreign subsidiaries in small amounts. (*Stip. Para.* 141). CCA purchased some paper from third parties and sent it to the subsidiaries who then reimbursed CCA; the amounts involved are unknown. (*Stip. Para.* 143). CCA assisted the subsidiaries in their purchase of equipment; and some equipment was purchased from CCA itself. (*Stip. Para.* 147). Ninety-eight percent of the equipment purchased by the Latin American subsidiaries was purchased with the acceptance of CCA's purchasing de-

partment. (*Stip. Para.* 148). CCA and all subsidiaries except two were audited by the same accounting firm (*Stip. Para.* 138). Accounting methods were not standardized among CCA and its subsidiaries, however, CCA strove to attain efficient accounting systems and procedures. (*Stip. Para.* 139). Where a subsidiary recommended expansion into a market unfamiliar to the subsidiary, CCA made a study of the situation. The final decision whether to move into a new market was made by CCA. (*Stip. Para.* 28). Major policy matters of the subsidiaries were generally subject to review by CCA. (*Stip. Para.* 74). Although CCA had a policy of "reaching decisions by mutual understanding rather than domination" CCA held management of the subsidiaries strictly responsible for their performance. (*Stip. Para.* 130). Finally, CCA loaned substantial amounts of money to its subsidiaries and guaranteed approximately one-third of loans obtained by the subsidiaries from other sources. (*Stip. Para.* 133). The fact that a subsidiary can turn to its parent for financial help is substantial evidence of unity of operation. *Chase Brass & Copper Co. v. Franchise Tax Board,* 10 Cal. App. 3d 496 (1970).

CCA had control of major policy matters which is an important element of unity of use. And CCA did make some sales to its subsidiaries. Rf: *Chase Brass & Copper Co. v. Franchise Tax Board, supra.* In addition to CCA holding of the management of subsidiaries strictly responsible for their performance, there were CCA representatives on the board of directors of almost all the subsidiaries. (*Stip. Paras.* 78, 94 and 110; and Exhibit E). CCA had a foreign operations staff responsible for over-

seeing the subsidiaries and for proving a channel of communications between CCA and the subsidiaries (*Stip. Paras.* 144-146). Such a flow is an element of unity of use. See *Honolulu Oil Corp. v. Franchise Tax Board, supra;* and *Superior Oil Corp. v. Franchise Tax Board, supra,* at 416.

The Court further finds that based on these facts there are contributions and dependencies between CCA's in-state business and its out-of-state business. Therefore, the formula allocation of income must be used. *Butler Brothers v. McColgan, supra.* The only limitation on the use of the formula allocation of income is that it "must not produce an unreasonable result." Id. at 671. An unreasonable result has not been demonstrated by plaintiff. Furthermore, the operations within and without the state need not be "necessary and essential" to each other and to the business as a whole for the in-state operations to be an integral part of a unitary business. *Superior Oil Corp. v. Franchise Tax Board, supra,* at page 413-414.

II.

The Court finds that the fact that CCA's subsidiaries are located outside the United States does not render invalid the application of formula apportionment. The fact that a business operates in foreign countries, rather than only in foreign states, does not prevent the Court from finding that CCA and its foreign subsidiaries constitute a unitary business. (See *Superior Oil Corporation v. Franchise Tax Board, supra,* and *Honolulu Oil Corporation v. Franchise Tax Board, supra.*) The Court is satisfied that such a finding does not contravene any constitutional provisions.

CCA has failed in its proof to demonstrate that the application of formula apportionment would deny it due process. The United States Supreme Court has upheld the unitary treatment of a foreign corporation and its in-state operations against due process challenges. (See *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission* (1924) 266 U.S. 271.) Similarly, application of formula apportionment would not violate the Commerce Clause. In *Bass, Ratcliff & Gretton, supra,* the unitary treatment of a foreign corporation and its in-state operations was upheld against Commerce Clause challenges.

The Court finally finds that *Japan Line, Ltd. v. County of Los Angeles* ..... U.S. ..... 47 U.S. Law Week 4477 (1979) is distinguishable from the facts herein and not applicable. The Court did not reach the question of "the taxability of foreign-owned instrumentalities engaged in interstate commerce or of domestically-owned instrumentalities engaged in foreign commerce." Id. at ..... N. 7, U.S. Law Week at 4480 N.7.

The Court therefore finds for defendant Franchise Tax Board and against plaintiff Container Corporation of America. Upon proper demand and in accordance with Rule of Court 232, defendant is to prepare findings of fact, conclusions of law, consistent with the opinions herein.

Dated: Sept. 11, 1979.

/s/ DANIEL M. HANLON

Daniel M. Hanlon
Judge, Superior Court

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Superior Court of the State of California
City and County of San Francisco

No. 673 492

Container Corporation of America,
Plaintiff,

vs.

Franchise Tax Board,
Defendant.

(Marked Filed by Court Clerk October 23, 1979)

JUDGMENT AFTER TRIAL BY COURT

The above-entitled matter came on regularly for trial on February 23, 1978, at 11:25 a.m., Plaintiff appearing by its attorneys Morrison & Foerster by Franklin C. Latcham and Prentiss Willson, Jr., and defendant appearing by its attorneys Evelle J. Younger, Attorney General, by Philip M. Plant, Deputy, and this being a proceeding properly triable by the court without any jury; the court having heard the testimony and considered the evidence together with written and oral argument; the Court having filed its notice of intended decision on September 14, 1979; and findings not having been requested; and good cause appearing therefor:

It Is Hereby Ordered, Adjudged and Decreed that plaintiff Container Corporation of America take nothing by its action; and that defendant Franchise Tax Board recover its costs in the amount of $.....

Dated: October 19, 1979.

Daniel M. Hanlon

Daniel M. Hanlon, Judge

Approved as to Form:
Morrison & Foerster

By: /s/ Franklin C. Latcham

Attorneys for Plaintiff
Container Corporation of America

Appendix C

CONTAINER CORPORATION OF AMERICA

Parent and Non-One Hundred Percent Owned Subsidiaries of Container Corporation of America

Parent: Mobil Corporation

Subsidiaries:

DOMESTIC

T. R. Miller Mill Company, Inc.

FOREIGN

Carton de Colombia, S.A.

Compania Colombiana de Empaques Bates, S.A.

Occidental de Empaques, Ltda.

Industria de Carbon del Valle del Cauca, S.A.

Reforestadora del Cauca, S.A.

Carton de Venezuela, S.A.

Fibras Internacionales de Puerto Rico

Molinos de Carton y Papel, S.A.

Cartones Nacionales, S.A.

Cartoenvases Valencia, S.A.

Corrugadora de Carton, S.A.

Union Grafica, S.A.

Appendix D

Court of Appeal of the State of California
in and for the
First Appellate District

Division Four

No. 48990

Container Corporation of America,
Plaintiff and Appellant,

vs.

Franchise Tax Board,
Defendant and Respondent.

(Marked Filed by Court Clerk May 4, 1981)

By the Court:

The petition for rehearing is denied.

Dated May 4, 1981

Caldecott, P.J.

Appendix E

Order Denying Hearing
After Judgment by the Court of Appeal
1st District, Division 4, Civil No. 48990

In the Supreme Court of the State of California

In Bank

Container Corporation of America

v.

Franchise Tax Board

Appellant's petition for hearing Denied.

(Marked Filed by Court Clerk June 17, 1981)

Bird
Chief Justice

Appendix F

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In the Court of Appeal
of the
State of California

First Appellate District

Division Four

1 Civil No. 48990

Container Corporation of America,
Plaintiff and Appellant,

vs.

Franchise Tax Board,
Defendant and Respondent.

(Marked Filed by Court Clerk July 31, 1981)

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that Container Corporation of America, the Plaintiff and Appellant above-named, hereby appeals to the Supreme Court of the United States from

the entire final judgment of the Court of Appeal of the State of California entered in this action on April 14, 1981 (Petition for Rehearing denied by the Court of Appeal on May 4, 1981; Petition for Hearing denied by the Supreme Court of California on June 17, 1981), affirming the judgment of the Superior Court of the State of California, in and for the City and County of San Francisco.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Dated: July 31, 1981.

Franklin C. Latcham
Prentiss Willson, Jr.
Thomas H. Steele
Morrison & Foerster

By FRANKLIN C. LATCHAM

Franklin C. Latcham
Counsel for Plaintiff
and Appellant

Appendix G

Title 18, California Administrative Code, § 25120: . . .

(b) Two or More Businesses.—One corporate entity may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the business the income of which is being apportioned.

Example: The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing tobacco products. The third division produces and distributes motion pictures for theaters and television. Each division operates independently; there is no strong central management. Each division operates in this state as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate "trades or businesses." Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this state is determined by applying an appropriate apportionment formula to the business income of each business.

The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts of each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the divisions under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a

whole. The following factors are considered to be good indicia of a single trade or business; and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will most always be engaged in a single trade or business.

* * *

Appendix H

Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries[1]

Country	Year 1967	1968	1969
United States	$2.83	$3.01	$3.19
Australia	1.21M	1.28M	1.36M
	.75F	.89F	.96F
Austria	.88	.93	.99
Barbados	.34	.39	.43
Belgium	1.04M	1.09M	1.19M
	.67F	.71F	.77F
Brazil	.38	.35	.41
Burma	.18M	.17M	.17M
	.15F	.14F	.15M
Canada	2.22	2.40	2.60
Chile	.36	.36	.38
Colombia	.29	.30	.31
Denmark	1.62	1.80	2.02
Ecuador	.20	.22	.31
Finland	1.00M	1.12M	1.21M
	.69F	.77F	.85F
France	.69	.77	.76
Germany, F.R.	1.25M	1.30M	1.55M
	.86F	.90F	1.08F
Ghana	.28	.31	.33
Greece	.42	.46	.50
Italy	.68	.71	.78
Japan	.65	.77	.91
Malawi		.11	.17
Mexico	.62	.65	.68
New Zealand	.92	.97	1.28
Norway	1.46M	1.57M	1.72M
	1.07F	1.17F	1.28F
Philippines	.24	.24	.25
Puerto Rico	1.39	1.55	1.65
Spain	.41	.45	.50
Sri Lanka	.13	.14	.14
Sweden	1.91M	2.02M	2.21M
	1.47F	1.57F	1.74F
Switzerland	1.33	1.42	1.49
United Kingdom	1.16	1.23	1.34
Venezuela	.99	1.07	1.04

[1]Source: United Nations, monthly Bulletin of Statistics, December 1972, Table 57, at 148, based on data from International Labour Office.

M refers to wages of males and F, wages of females; in other countries single composite figures are given. Figures normally in-

clude bonuses, cost of living allowances, taxes, social insurance contributions payable by the employed person and, in some cases, payments in kind. They normally exclude social insurance contributions payable by the employers, family allowances and other social security benefits. In a few instances, family allowances and salaried employees have been included in the figures. The information published by the United Nations is stated in terms of the local currency, which we have translated into dollars by the applicable midpoint exchange rates (in most cases) published in the United Nations Statistical Report, p. 216. In these cases in which daily, weekly, or monthly wage rates are given in the U.N. figures, we have assumed an 8-hour day, 44-hour week or 190.5-hour month for conversion purposes, which we regard as highly conservative. The foregoing table omits some of the countries as to which information is provided, most of which are in the Soviet bloc. In all cases with respect to the countries omitted, the average hourly earnings are substantially below those of the United States.

Appendix I

Percentage of U.S. Average Hourly Compensation, Adjusted for Estimated Differences in Productivity[1]

Country	1969	1970
Japan	40	40
West Germany	61	72
United Kingdom	65	68
Belgium	60	61
Canada	79	82
France	58	54
Italy	62	67
Netherlands	74	71
Sweden	72	74

[1]Source: United States Tariff Commission, *Competitiveness of U.S. Industries* (T.C. Publication 473) at 30 (1972).

No. 81-523

Office-Supreme Court, U.S.
FILED
NOV 12 1981
ALEXANDER L. STEVAS,
CLERK

IN THE SUPREME COURT
Of The
UNITED STATES

October Term, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,
vs.
FRANCHISE TAX BOARD,
Appellee.

On Appeal From the Court of Appeal
of the State of California
for the First Appellate District

MOTION TO NOTE PROBABLE JURISDICTION AND TO HEAR CASE IN TANDEM WITH CHICAGO BRIDGE & IRON, ASARCO AND WOOLWORTH CASES

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November 11, 1981.

TABLE OF AUTHORITIES

Cases

Page

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Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinois Department of Revenue, 84 Ill. 2d 102, 417 N.E. 2d 1343 (1981), prob. juris. noted, No. 81-349 (U.S. Sup. Ct. November 9, 1981).....1, 5

F. W. Woolworth Co. v. Taxation and Revenue Department, 95 N.M. 519, 624 P.2d 28 (1981) prob. juris. noted, No. 80-1745 (U.S. Sup. Ct. October 5, 1981).....1, 5

MOTION TO NOTE PROBABLE JURISDICTION AND TO HEAR CASE IN TANDEM WITH CHICAGO BRIDGE & IRON, ASARCO AND WOOLWORTH CASES

For the reasons which follow, appellant respectfully moves the Court to note probable jurisdiction in Container Corporation of America v. Franchise Tax Board, No. 81-523, and to hear that case in tandem with Chicago Bridge & Iron Company v. Caterpillar Tractor Co., Illinois Department of Revenue, et al., No. 81-349, prob. juris. noted, Nov. 9, 1981; Asarco Inc. v. Idaho State Tax Commission, No. 80-2015, prob. juris. noted, October 5, 1981; and F. W. Woolworth Co. v. Taxation and Revenue Department, No. 80-1745, prob. juris. noted, October 5, 1981.

On Monday, November 9, 1981, the Court noted probable jurisdiction in the Chicago Bridge & Iron Company ("CBI")

case, to be heard in tandem with the Asarco and Woolworth cases. The Court took no action in the Container Corporation of America ("Container") case. Appellant suggests that it would be helpful to the Court to note probable jurisdiction in the Container case because of the fully developed record in the case relating to the constitutional issues involved as opposed to the CBI case which does not have such a record.

The record in the Container case was specifically developed to provide a basis for considering the constitutional issues which arise from the application of worldwide unitary combination to a United States corporation and its foreign subsidiaries and affiliates. The Container record sets forth the severe misattribution of income from the Container foreign subsidiaries to the parent company and

to California resulting from the application of worldwide combination. The record also presents graphic examples of double taxation of income as a result of the imposition of tax by California and by the countries in which the subsidiaries operate, particularly Colombia, Venezuela and Holland.

Therefore the record in the Container case (which is based upon a stipulation of facts and undisputed expert testimony) specifically illustrates how worldwide unitary combination causes the taxing state to tax income earned outside the state, and indeed outside the United States, in violation of the due process and commerce clauses. The record also demonstrates why such combination results in multiple taxation and prevents the federal government from speaking with one voice in the field of

foreign tax policy in violation of the commerce clause. These important constitutional issues have not previously been considered by this Court.

On the other hand, the record in the CBI case was not developed to present these constitutional issues. That record was developed by Caterpillar Tractor Company and the Illinois Department of Revenue, who agreed upon the application of worldwide unitary combination to Caterpillar and only disagreed about certain state issues. These state issues are not presented to this Court by CBI. CBI was one of several intervenors in the Caterpillar Tractor case before the Illinois courts, and, as such, did not present evidence in the case.

It is respectfully submitted, therefore, that it would be helpful to

the Court to note probable jurisdiction in the Container case, thereby providing the Court with a fully developed record upon which to consider the important constitutional issues raised by worldwide unitary combination.

In order to expedite the Court's consideration of the Container case in tandem with the CBI, Asarco and Woolworth cases, Appellant is prepared to submit its opening brief within the same time period afforded CBI for filing its opening brief, i.e., 45 days from November 9, 1981.

Counsel for CBI have stated that they have no objection to the

motion herein made by counsel for Container.

Dated: November 11, 1981

Respectfully submitted,

FRANKLIN C. LATCHAM
Counsel of Record

PRENTISS WILLSON, JR.
Counsel for Appellant
Container Corporation
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Of Counsel

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Office - Supreme Court, U.S.
FILED
NOV 18 1981
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No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal
of the State of California for the
First Appellate District

OPPOSITION TO APPELLANT'S MOTION TO NOTE PROBABLE JURISDICTION AND HEAR IN TANDEM WITH OTHER CASES

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TABLE OF AUTHORITIES CITED

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	Pages
Federal:	
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No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

OPPOSITION TO APPELLANT'S MOTION TO NOTE PROBABLE JURISDICTION AND HEAR IN TANDEM WITH OTHER CASES

On Friday, November 13, 1981, counsel for appellee (FTB) received Appellant's ("CCA'S") "Motion to Note Probable Jurisdiction and to Hear Case in Tandem with Chicago Bridge & Iron, Asarco and Woolworth Cases." The Clerk of this court was immediately advised by telephone of FTB'S opposition. The Clerk advised counsel that the Court would

consider this case on November 25 and opposition (in typewritten form) should reach the court by Wednesday November 18, 1981.

Appellee Franchise Tax Board OPPOSES appellant Container Corporation's motion for the reasons stated hereinafter, as well as those contained in FTB'S "Motion of Appellee to Dismiss or Affirm" filed herein in October 1981.

CCA incorrectly asserts that this case brings this court a fully developed record relating the constitutional issues.

The primary issue presented by CCA throughout this case is whether all (or some) of CCA'S foreign operations were part of its unitary business. CCA operated in 7 foreign countries through 19 subsidiaries. (CT 194-95.) Many pages of exhibits and evidentiary facts

were received and evaluated by four California judges on two courts who unanimously concluded that such operations were in fact part of CCA'S unitary business. The trial court specifically found "contributions and dependencies" requiring use of formula apportionment and that CCA failed to demonstrate any "unreasonable result" from use of the formula (Jurisdictional Statement [hereinafter J.S.], p. A-30.)

In its statement of the issues before this Court CCA assumes facts contrary to those determined by the California courts. Thus CCA is apparently asking this Court to reexamine the evidence and make factual determinations contrary to those of the lower courts. Such a factual reexamination is certainly not appropriately undertaken in tandem with three entirely separate cases

-- as CCA'S motion requests. FTB believes it should not be undertaken by this Court at all.

The primary evidence presented in this case bearing on the constitutional issues consisted of testimony of five witnesses.[1/] Contrary to CCA'S representations this testimony and the inferences to be drawn therefrom and effect thereof were strongly disputed by appellee. The trial court limited the testimony of three of the witnesses to a comparison of Colombia with California operations. (CT 146.) The trial court rejected such testimony, holding that "CCA has failed in its proof to

---

1. One witness testified orally. The parties stipulated to the testimony of four other witnesses. Under California law the effect is the same as if they had testified orally.

demonstrate that the application of formula apportionment would deny it due process." and "similarly, application of formula apportionment would not violate the commerce clause." (J.S. p. A-31.)

This case was tried under California rules of evidence, burden of proof and scope of review. Such California law similarly controls the facts to be considered on appeal therefrom. Under California law, a trial court determination contrary to testimony of a witness precludes consideration of such testimony on appeal. CCA had the opportunity to request Findings of Fact, but chose not to do so. (J. S., p. A-31.) Therefore, all facts must be considered to have been found against the appellant, CCA.

The testimony of CCA'S witnesses on which CCA relied at trial, on constitutional issues, was rejected by the factual determinations of the trial court that CCA failed to carry its burden of proving unconstitutionality. Therefore such testimony simply cannot properly be used on appeal.

CCA in its Jurisdictional Statement also refers to statements totally outside the record -- which were never offered in evidence at trial -- to try to establish certain facts on which it now bases arguments of unconstitutionality. This too is improper. The consideration of this appeal should be solely upon the evidence presented to the trial court, not upon the out-of-court statements or writings which CCA merely refers to in its arguments. Nor should

the resolution of this case be based on any evidence presented in other cases.

This appeal involves only activities during 1963, 1964 and 1965 in Holland, Mexico, Colombia and Venezuela.[2/] Most testimony here applies solely to CCA'S operations. The trial court limited the use of much of the testimony. (CT 146.) FTB is not familiar with the records or details of the other three cases, but submits that it is highly

---

2. CCA also did business in Germany, Austria and Italy. However, under CCA'S own calculations (J. S., p. 11), CCA'S California tax was reduced, not increased, by their inclusion in the unitary business. Thus, CCA was benefitted, not injured, and cannot complain of any unconstitutionality thereby. The Panama subsidiary, a holding company, was not considered part of the unitary business. This also illustrates the fairness of California, which includes unitary activities where they reduce tax as well as those which increase tax. Tax assessments of under $16,000 for '63', $34,000 for '64' and $23,000 for '65' are in issue here.

doubtful that the respective records show that the CCA evidence is relevant and material to the determination of those cases. Further, such consideration of evidence in other cases would deprive opponents of the right to cross examination and violate universal rules of evidence and due process.

Because of the substantial changes in the economic and political relationships between various countries and areas of the world since the early 1960's, it is doubtful that determinations based on the facts of this case will have any substantial value for future cases.

CCA appears to concede that this case boils down to a question whether it can require California to tax it based on its own separate accounting methods (See Brief in Opposition to

Motion to Dismiss, p. 3.) It totally ignores the thorough analysis and clear language of this court in Mobil Oil Corp. v. Vermont (1980) 445 U.S. 425 (Id., p.4) and asks this court to speculate about situations not before the court. (Id., p. 5.)

This case involves a relatively small amount of tax arising from activities in a single type of business (paperboard) in four countries, at least three of which have developed and changed substantially in the almost two decades since the three years in issue. It should be resolved on its own facts, which were found against CCA below. It is of little value for future guidance.

CONCLUSION

Probable jurisdiction should NOT be noted. This Court in Mobil has recently set out the guidelines for state income taxation of foreign unitary businesses. Following these guidelines, four judges have unanimously agreed that the evidence before the court showed that CCA'S foreign subsidiaries were part of its unitary business and did not establish that formula apportionment violated CCA'S constitutional rights. This case would be of little precedential value. The Motion to Dismiss or Affirm should be granted.

Should the court be inclined to note probable jurisdiction: (a) it should consider it only on the evidence properly presented in the trial court, and usable on appeal under the California rules of evidence, burden of proof and scope of

SUPREME COURT OF THE UNITED STATES

No. 81-523, October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

CERTIFICATE OF SERVICE

I, Neal J. Gobar, one of the attorneys for the Franchise Tax Board, appellee herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 17th day of November, 1981, I served copies of the foregoing Opposition to Appellant's Motion to Note Probable Jurisdiction and Hear in Tandem with Other Cases on several parties thereto, as follows:

On the Container Corporation of America, appellant, by mailing three copies in a duly addressed envelope, with first-class postage prepaid, to its attorneys of record, as follows:

Franklin C. Latcham
Counsel of Record
Prentiss Willson, Jr.
One Market Plaza
Spear Street Tower, 34th Floor
San Francisco, California 94105

It is further certified that all parties required to be served have been served in accordance with Supreme Court Rule 28.

NEAL J. GOBAR
Deputy Attorney General

Attorneys for Appellee
Franchise Tax Board

Office - Supreme Court, U.S.
FILED
APR 26 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA, APPELLANT

v.

FRANCHISE TAX BOARD, APPELLEE

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

SECOND MOTION OF APPELLANT TO EXPEDITE NOTING OF PROBABLE JURISDICTION

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TABLE OF AUTHORITIES

Cases

	Page
Chandler v. Judicial Council of the Tenth Circuit, 398 U.S. 74 (1970)	2
Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 84 Ill.2d 102, 417, N.E.2d 1343 (1981), prob. juris. noted, No. 81-349 (U.S. Sup. Ct. November 9, 1981)	1,2
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	3
Rescue Army v. Municipal Court, 331 U.S. 549 (1947)..	2

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

No. 81-523

CONTAINER CORPORATION OF AMERICA, APPELLANT

v.

FRANCHISE TAX BOARD, APPELLEE

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

SECOND MOTION OF APPELLANT TO EXPEDITE
NOTING OF PROBABLE JURISDICTION

On November 12, 1981, appellant filed a motion to note probable jurisdiction and to hear this case in tandem with Chicago Bridge & Iron Company v. Caterpillar Tractor Co., et al., No. 81-349; Asarco Inc. v. Idaho State Tax Commission, No. 80-2015; and F. W. Woolworth Co. v. Taxation and Revenue Department, No. 80-1745.*/ Although the Court denied our motion on November 30, 1981, and is apparently holding this case to await the disposition of Chicago Bridge & Iron Company, the colloquy between the Court and counsel in the oral argument in the Chicago Bridge & Iron Company case on April 19, 1982, compels us respectfully to renew the motion.

---

*/ Appendix C of appellant's Jurisdictional Statement contains a listing of appellant's parent and non-one hundred percent owned subsidiaries.

During the oral argument, several members of the Court expressed concern with respect to the adequacy of the record in the Chicago Bridge & Iron Company case and whether the Court could, in that case, resolve the question of whether Illinois' imposition of its income tax on apportioned combined worldwide business income violates the Commerce Clause. We share those concerns as to the adequacy of the record in that case.

As the Solicitor General pointed out in his Memorandum for the United States as Amicus Curiae in the Chicago Bridge & Iron Company case (pp. 4-7), there is no doubt that there is a case or controversy in that case under Article III insofar as acceptance of Chicago Bridge & Iron Company's constitutional claim will set aside the judgment in favor of Caterpillar Tractor Company. There are, however, other jurisprudential considerations that we believe the Court should take into account in determining whether that case is the appropriate vehicle for adjudicating the important constitutional question at stake. As the amicus Financial Executives Institute points out in its brief (pp. 16-24), the Court generally declines to adjudicate issues that "come to [it] in highly abstract form. . . . [J]urisdiction . . . should be exerted only when the . . . question presented . . . tenders the underlying constitutional issues in clean-cut and concrete form . . . ." Rescue Army v. Municipal Court, 331 U.S. 549, 575-84 (1947). There is accordingly a "long-settled doctrine that this Court will not determine constitutional questions . . . in a case that does not present them with sufficient clarity to make possible the circumspect consideration they require." Chandler v. Judicial Council of the Tenth Circuit, 398 U.S. 74, 92 (1970) (Harlan, J., concurring). This doctrine is

of particular importance in these cases which involve issues sensitive to the conduct of the Nation's foreign relations.

The use by the states (here California) of the worldwide unitary combination method raises the additional considerations addressed by the Court in Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 451 (1979) in regard to state taxation of foreign commerce, as distinguished from interstate commerce, i.e. (i) the enhanced risk of double taxation and (ii) the impairment of federal uniformity. We submit that the Court should consider these issues, as it did in Japan Line, based upon a record in which double taxation is actually demonstrated. Absent such a record the Court would have to decide these important constitutional issues in a context where the basic problem of double taxation is not established. In our view, such a course of action would be particularly inappropriate insofar as the federal policy under consideration in these cases was adopted to avoid double taxation in regard to income taxes. We therefore believe that it is important for the Court to consider the impact of state income taxation upon such policy in a case with a record in which double taxation actually exists. For these reasons, we submit that the Court should note probable jurisdiction in Container Corporation of America v. Franchise Tax Board to enable these important constitutional issues to be decided on the well-developed record in this case that was totally stipulated except for the uncontroverted testimony of one expert witness. Accord, Memorandum for the United States as Amicus Curiae, pp. 7-8, n.3, 15, 18.

In renewing our request for plenary consideration, we do so with a keen awareness of the limitations of, and heavy demands upon, the Court's docket and the need to avoid

full briefing and argument in duplicative cases. But we believe that the need to consider the important constitutional questions at stake in these cases in the context of a fully developed record far outweighs the additional burden that may ensue. Nor do we intend, by this request, to derogate the merits of Chicago Bridge & Iron Company's claim for relief. Furthermore, we do not attribute the insufficiency of the record in that case to any inaction on the part of the appellant. Under Illinois procedure, Chicago Bridge & Iron Company, as an intervenor, was barred from introducing any evidence. But, had it failed to intervene, it would have been faced with a contrary Illinois precedent on both its statutory and constitutional claims. Hence, Chicago Bridge & Iron Company took every possible action to preserve its claim for relief.

Accordingly, at this juncture, we submit that the fairest course of action to all the parties that would be consistent with the circumspect consideration that the issue in these cases deserves, and indeed requires, is for the Court to defer decision in Chicago Bridge & Iron Company and note probable jurisdiction in Container Corporation of America No. 81-523.**/

**/ We are serving copies of this motion upon Counsel for the parties in the Chicago Bridge & Iron Company case and the California Franchise Tax Board.

CONCLUSION

Probable Jurisdiction should be noted.

Respectfully submitted.

Dated: April 26, 1982

FRANKLIN C. LATCHAM
Counsel of Record

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Counsel for Appellant
Container Corporation
of America

Of Counsel

MORRISON & FOERSTER

AFFIDAVIT OF SERVICE BY MAIL

District of Columbia)
Washington, D.C.) ss.

JAMES E. MERRITT, being first duly sworn, says:

That affiant is a citizen of the United States, over 18 years of age, and not a party to the within cause; that affiant's business address is 1920 N. St., N.W. Washington, D.C. 20036; that affiant served the required number of copies of the attached

SECOND MOTION OF APPELLANT TO EXPEDITE NOTING OF PROBABLE JURISDICTION

on each of the following by placing same in an envelope addressed (respectively) as follows:

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Tyrone C. Fahner (1 copy)
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San Diego, CA 92101

George Deukmejian (1 copy)
Attorney General of California
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San Francisco, CA 94102

that each of said envelopes was then, on April 26, 1982, sealed and deposited in the United States mail at Washington, D.C., with the postage thereon fully prepaid; and that there is delivery service by United States mail at each place so addressed, or that there is regular communication by mail between the place of mailing and each place so addressed.

Affiant certifies that all parties required to be served have been served.

James E. Merritt

Subscribed and sworn to before me this 26th day of April, 1982.

Patricia G. Wakely

NOTARY PUBLIC in and for the District of Columbia.

My Commission Expires January 1, 1985

Office - Supreme Court, U.S.
FILED
JUL 19 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

vs.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal
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for the First Appellate District

JOINT APPENDIX

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APPEAL DOCKETED SEPTEMBER 14, 1981
PROBABLE JURISDICTION NOTED MAY 3, 1982

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TABLE OF CONTENTS

Chronological List of Relevant Docket Entries 1

Table of Contents to Stipulation of Facts 2

Stipulation of Facts 5

Addendum to Stipulation of Facts 81

Second Addendum to Stipulation of Facts 83

Stipulation re Testimony 88

Reporter's Transcript of Proceedings 118

Superior Court of the State of California
for the City and County of San Francisco

No. 673492

Container Corporation of America,
Plaintiff,

vs.

Franchise Tax Board,
Defendant.

[Filed Feb. 23, 1978]

TABLE OF CONTENTS TO STIPULATION OF FACTS

	paragraph number	page
I. INTRODUCTION	1	5
II. BACKGROUND OF ACTION	8	6
III. BACKGROUND OF CCA	23	13
IV. BACKGROUND OF FOREIGN SUBSIDIARIES	25	14
V. OPERATIONS OF CCA	29	17
1. *Paperboard*		
(a) General	35	20
(b) Raw Materials and Production	36	20
(c) Containerboard	37	21
(d) Boxboard	38	21

	paragraph number	page
2. *Production of Packaging Material*		
(a) General	43	22
(b) Corrugated Containers	44	22
(c) Folding Paperboard	52	25
(d) Composite Cans	55	26
VI. ACTIVITIES OF FOREIGN SUBSIDIARIES—GENERAL	61	30
VII. ACTIVITIES OF FOREIGN SUBSIDIARIES—BY COUNTRY		
A. *Colombia*		
1. Development of Carton de Colombia, S.A.	77	41
2. Materials	83	44
3. Products	86	46
4. Marketing	88	47
5. Personnel	89	48
6. Independent Stock Ownership	90	48
B. *Venezuela*		
1. Materials	91	48
2. Products	92	49
3. Marketing	93	50
4. Personnel	94	50
C. *Mexico*		
1. Materials	96	51
2. Products	100	53
3. Marketing	104	54
4. Personnel	108	55

	paragraph number	page
D. *Holland*		
1. Background	110	56
2. Materials Used for Production	111	56
3. Products	115	58
4. Marketing	116	58
VIII. RELATIONSHIP OF CCA TO THE FOREIGN SUBSIDIARIES		
A. Personnel	119	60
B. Loans	133	69
C. Financial Reporting By Subsidiaries	134	70
D. Legal and Accounting	138	72
E. Intercompany Sales	141	73
F. Technical Service Agreements	144	74
G. Purchase of Equipment	147	76
H. Miscellaneous	149	78

Superior Court of the State of California
for the City and County of San Francisco
[Title Omitted in Printing]

I.

STIPULATION OF FACTS

1. IT IS HEREBY STIPULATED AND AGREED by and between the parties hereto, through their respective attorneys of record, for purposes of this case only, that the following facts shall be taken as true and shall be adopted as part of the Court's findings of fact. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated herein, and the parties hereto expressly reserve the right to argue the relevancy or materiality of any of the facts herein stipulated to be true.

2. Except as otherwise provided herein, all exhibits attached hereto, or otherwise incorporated herein by reference, are included for the limited purpose of showing the contents thereof and not for the truth of the matters therein set forth. Provided, however, that either party may offer any of such documents for additional purposes subject to objections as to competency, relevancy and materiality but not subject to the best evidence objection or any objection as to their genuineness or the due execution thereof.

3. Nothing herein contained shall be construed as a waiver by any of the parties hereto of their rights to review on appeal any question of law or fact arising in this action in the same manner and to the same extent

as if the facts herein set forth had been proved in open court.

4. Each party may introduce at the trial of this cause any other or further evidence which is not inconsistent with the facts stated herein. To the extent possible, notice of each intended introduction shall be given to the other party sufficiently in advance of trial to enable the other party to meet such evidence.

5. The parties will make any computations necessary for inclusion in appropriate findings after the court's decision in this matter. In the event the parties are unable to agree on the computation, the case may be reopened by either party to submit any additional evidence which may be required in making such computation.

6. Except as otherwise noted, the facts set forth herein pertain only to the calendar years 1963-1965.

7. This stipulation shall be valid only in the above-entitled action.

II.

BACKGROUND OF ACTION

A.

8. This action involves a suit for refund of franchise taxes paid under the Bank and Corporation Tax Law for the income years (i.e., calendar years) 1963, 1964 and 1965 (taxable years 1964, 1965 and 1966).

B.

9. At all times mentioned herein, Container Corporation of America (hereinafter "CCA") was and is a cor-

poration organized and existing under and by virtue of the laws of the State of Delaware. At all times mentioned herein CCA had its principal executive offices in the State of Illinois.

C.

10. The following facts have been admitted in the pleadings: During the income years 1963, 1964 and 1965 CCA owned a controlling interest in subsidiaries located in Western Europe and Latin America; with respect to all but the Colombian subsidiaries, stock not owned by CCA or its agents is owned by nationals of the particular foreign country. (Since 33% of the stock of Carton de Colombia is traded on a Colombian exchange, it cannot be determined with certainty that all owners were, or are, Colombians.) Throughout this stipulation these subsidiaries will be referred to collectively as the "foreign subsidiaries." Greater detail regarding the foreign subsidiaries is provided in sections VI and VII below.

D.

11. Concurrent with the filing of its Bank and Corporation Franchise Tax returns for income years 1963, 1964 and 1965, CCA paid or had previously paid franchise taxes to the Franchise Tax Board on the dates and in the amounts reflected below:

1. Income Year 1963

Date	Type of Payment	Amount
March 15, 1964	estimated	$142,000.00
September 15, 1964	with return	$ 21,172.01

2. Income Year 1964

Date	Type of Payment	Amount
March 15, 1965	estimated	$153,000.00
September 14, 1965	with return	$ 15,422.14

3. Income Year 1965

Date	Type of Payment	Amount
June 15, 1965	estimated	$ 43,415.00
September 15, 1965	estimated	$ 5,848.70
March 15, 1966	estimated	$110,736.30
September 15, 1966	with return	$ 14,590.29

E.

12. On January 23, 1969 the Franchise Tax Board issued to CCA three Notices of Additional Tax Proposed to be Assessed for the income years and in the amounts reflected below:

No.	Income Year	Taxes Assessed
J138788	1963	$15,304.87
J138789	1964	$33,888.82
J138790	1965	$22,750.41

Copies of these notices are attached to the complaint as Exhibit A to Exhibit 2, Exhibit A to Exhibit 5 and Exhibit A to Exhibit 7 for taxable years 1964, 1965 and 1966, respectively.

F.

13. On March 17, 1969, CCA filed with the Franchise Tax Board a protest of the three proposed assessments described in paragraph E above. A copy of this protest is attached to the complaint as Exhibit A of Exhibit 2.

G.

14. On April 28, 1969, CCA paid to the Franchise Tax Board $37,970.15 which amount was the result of certain federal adjustments made for income years 1963, 1964 and 1965. The amount attributable to tax and interest for each income year is reflected below:

Income Year	Tax	Interest
1963	$10,092.40	$3,095.00
1964	$11,609.90	$2,863.77
1965	$ 8,687.43	$1,621.65

This payment was made under cover of a letter from CCA to the Franchise Tax Board a copy of which is attached to the complaint as Exhibit E to Exhibit 2. Receipt of said letter was acknowledged by the Franchise Tax Board.

H.

15. On June 20, 1973, CCA paid additional franchise taxes, including interest, to the Franchise Tax Board for income years 1963, 1964 and 1965. The amount attributable to tax and interest for each income year is reflected below:

Income Year	Tax	Interest
1963	$15,304.87	$ 8,494.20
1964	$33,888.82	$16,774.97
1965	$22,750.41	$ 9,896.43

This payment was made under cover of a letter from CCA to the Franchise Tax Board a copy of which is attached to the complaint as Exhibit D to Exhibit 2. Receipt of said letter was acknowledged by the Franchise Tax Board.

I.

16. On August 2, 1973, the Franchise Tax Board affirmed without adjustment the three proposed assessments described in paragraph E above. CCA was advised of this action by three Notices of Action on Taxpayer's Protest mailed to it by the Franchise Tax Board on the same date. Copies of the Notices of Action on Taxpayer's Protest are attached to the complaint as Exhibit C to Exhibit 2, Exhibit C to Exhibit 5 and Exhibit C to Exhibit 7 for income years 1963, 1964 and 1965, respectively.

J.

17. On October 26, 1973 CCA filed with the Franchise Tax Board three claims for refund for income years 1963, 1964 and 1965 in the amounts reflected below:

Income Year	Amount
1963	$31,118.00
1964	$49,059.20
1965	$46,828.93

Copies of these claims for refund are attached to the complaint as Exhibits 2, 5 and 7 for income years 1963, 1964 and 1965, respectively.

K.

18. On October 29, 1973, the Franchise Tax Board issued to CCA Notices of Assessment for the income years and in the amounts reflected below:

Income Year	Amount
1963	$11.95
1964	$32.02
1965	$21.49

Copies of these Notices of Assessment are attached to the complaint as Exhibit 3. On November 2, 1973, CCA paid in full these assessments.

L.

19. On January 11, 1974, the Franchise Tax Board issued to CCA Notices of Action denying the three claims for refund of CCA described in paragraph J above except for the partial refunds reflected below:

Income Years	Refund
1963	$3,443.26
1964	$3,913.67
1965	$2,842.06

20. With regard to the balance claimed, CCA's claims for refund were denied by the Franchise Tax Board. Copies of these Notices of Action are attached to the complaint as Exhibits 4, 6 and 8.

M.

21. It is stipulated that the figures in Exhibits A and B to this stipulation are accurate. The net income figures for CCA and the foreign subsidiaries in Exhibit A are derived from the financial statements of CCA and the latter were included in Form 2952 which is attached to CCA's United States income tax return. The 2952s were the starting point for the California auditor in determining CCA's California tax liability. The income figures on p. 7 of Exhibit A are tax income (as opposed to financial income) figures. The 2952 information was prepared in accordance with the generally accepted accounting principles of the foreign country. In completing Form 2952,

"monetary items" (current assets and liabilities and long-term debt) were taken into account at the current exchange rate between the local currency and the U.S. dollar and "non-monetary accounts" (essentially plant and equipment, depreciation reserves, investments, capital stock, surplus and general inventory) were taken into account at the historical rate, i.e., the exchange rate in effect in the year when the items were entered on the subsidiaries' books. In computing this information, CCA's subsidiaries lump together all forms of revenue from sources other than the sale of products, subtract from that amount certain miscellaneous expenses and report a single net income figure for those sources of revenue.

N.

22. For the years in question the corporate franchise tax returns filed by CCA with the Franchise Tax Board did not include the foreign subsidiaries as part of a unitary business with CCA. In its administrative determinations made in this case, and in its answer filed herein, the Franchise Tax Board took the position that CCA and the foreign subsidiaries constituted one unitary business for purposes of the corporation franchise tax. In the franchise tax returns filed by CCA and in the protests, claims for refund and complaint filed by CCA, the position was taken that CCA was not involved in a unitary business with the foreign subsidiaries.

III.

BACKGROUND OF CCA

A.

23. CCA was incorporated under the laws of Delaware on June 18, 1926, as Container Corporation of America. CCA was the successor to an existing business known as the Chicago Mill and Lumber Company, founded in 1881 in Chicago by Hermann Paepcke. The primary activity of this company was the manufacture of wooden containers. By 1910 it was one of the largest lumber and box organizations in the United States. The company's interest in the possibilities of paperboard as an adjunct to wood in container production led to the purchase of the company's first paperboard mill in 1915. Upon the death of Hermann Paepcke in 1922, his son, Walter, took over control of the business. By this time the company had a second paperboard mill and two corrugated plants. At the time of incorporation there were approximately fourteen factories as well as various mills. The capital stock of CCA was first traded on the New York Stock Exchange on December 28, 1935. In 1938 CCA built a large new pulp mill in Florida which gave CCA the capacity to supply the raw materials for a large measure of its own production.

B.

24. In 1938 CCA's profits dipped to $29,470 from $1,784,000 in the preceding year. As a result CCA instituted an across-the-board system of regional decentralization. Each regional vice president was responsible for all phases of the operations (manufacturing, sales and general administration) of all properties. Plants and mills were

similarly organized with each general manager reporting on all phases of the operations to the appropriate regional vice president. It is the view of many people in the company that this decentralization reorganization was chiefly responsible for the successes of CCA in the 1940s and later years. This organizational pattern continues today. Decentralization is the result not only of the philosophy of CCA but also of the fact that the product produced is entirely custom made.

IV.

BACKGROUND OF FOREIGN SUBSIDIARIES

A.

25. During the years in question, CCA controlled twenty foreign subsidiaries which are listed below by name and year established or date of acquisition and grouped by country. All of the subsidiaries except Carton International, S.A. were engaged in some aspect of the paperboard/packaging business. CCA controlled no other foreign subsidiaries.

	Date Established	Date Acquired	Percentage of Ownership by CCA or a Subsidiary of CCA
Colombia			
Cellulosa y Papel de Colombia, S.A.	1961		66.7(C)
Carton de Colombia, S.A.	1944		66.8
Venezuela			
Corrugadora de Carton, S.A.	1953		80
Carton de Venezuela, S.A.		1954	80
Union Grafica, S.A.		1954	80
Cartones Nacionales, S.A.	1959		82
Fibras Industriales de Venezuela, S.A.	1960		80
Cartoenvases Valencia, S.A.(B)	1965		80

foreign subsidiaries. CCA did not expect to, nor did it subsequently, acquire raw materials or finished products from these subsidiaries. CCA did not expect to, nor did it except to the limited extent described below, sell raw materials or finished products to these subsidiaries, or to third parties in those foreign countries.

C.

27. In those instances where CCA or the subsidiaries or agents did not own 100% of a foreign subsidiary, participation by foreign nationals was felt to be desirable because it was hoped this would lead to more favorable consideration by the local government, minimize the sometimes adverse or antagonistic reaction experienced by United States-owned subsidiaries in foreign countries, assure the acceptance by the local business community, make local management more readily available to the new business and help make the particular subsidiary more responsive to local needs.

D.

28. The procedure CCA follows in examining the possibilities of acquisition or formation of foreign subsidiaries is dependent on the circumstances. If a subsidiary recommends increased involvement in a present market, or if a nonaffiliated company in that market approaches a member of the group with an offer to sell, or if a subsidiary suggests development of a neighboring market, the staff of the subsidiary will probably perform most of the necessary studies (since they already have an understanding of the relevant business, economic, social and political

factors). Where a recommendation is made to examine a market with which a CCA affiliate is not familiar, CCA's Control Staff will compile the study. When the information is compiled, it will be reviewed by CCA's Senior Vice President for Overseas Operations and possibly a member of the Control and Law Staffs (if an existing subsidiary is to be involved, its management will also review the study). Where an acquisition (or formation) appears desirable, the next step will again depend on the circumstances of the specific proposal. If an existing subsidiary is involved, its Management Committee and Board will review the proposal. Where preliminary approval is given, CCA's Management Committee and Board must pass on it. If approval is given at both of these levels, the Board of the subsidiary will act on the matter. If it approves, the transaction will occur, but if either the Management Committee or the Board of Directors of the subsidiary rejects the proposal, CCA must decide whether it wishes to proceed independently. In a situation where a subsidiary is not involved, CCA's Management Committee and Board will be the only bodies to make the determination.

V.

OPERATIONS OF CCA

A.

29. CCA is an integrated producer of paperboard packaging of various types, producing the paperboard from raw timber and wastepaper in recycling mills, and manufacturing paperboard packaging products from the paperboard. CCA's principal business is the manufacture and sale of corrugated and solid fiber shipping containers, fold-

ing cartons, fiber cans, other paperboard products, paperboard in the form of container board and boxboard, and plastic products consisting principally of packaging components. Based upon statistical reports of domestic industry trade associations, CCA's domestic shipments in 1963-65 of shipping containers and folding cartons represented 5-10% of the totals for those industries and its domestic production of paperboard in 1963-65 represented approximately 6% of the total production of paperboard by the industry. Domestic shipments included all sales and transfers from a domestic plant including sales to other CCA plants or to a CCA subsidiary.

B.

30. During the years in question approximately 46% of CCA's trade sales were accounted for by sales of corrugated and solid fiber shipping containers; approximately 35% by sales of folding cartons, fiber cans and plastic packaging, and approximately 19% by other products, primarily paperboard and paperstock not used in CCA's fabricating operations. Trade sales do not include sales to CCA plants or subsidiaries.

C.

31. CCA had in excess of 10,000 customers in the United States. During the years in question the aggregate sales to CCA's ten largest customers were approximately 15% of its domestic sales.

D.

32. Customers were generally solicited by the plant salesmen in particular assigned geographical areas. Some

customers called CCA directly and requested that CCA design a particular carton or container. Each CCA plant had its own sales force to cover a given geographical area to sell its specific type of manufactured product. CCA also had three regional sales offices to handle national accounts. Regional sales offices service domestic accounts. Foreign accounts with unrelated companies are generally promoted and serviced in one of two ways: A plant's existing domestic account establishes an operation in another country and requests that CCA supply it; or a plant salesman is based in or travels to another country to open an account with a new customer. (CCA's trade sales outside of the U.S. are generally to Canada or Puerto Rico).

E.

33. The basic business of CCA in the United States was the manufacture of container products to the order and specifications of customers. Businesses which utilize packaging in the sale of their products realize that the attractiveness of the package is very important in the sale of their product. Thus the business of CCA was not only manufacturing cartons tailored to the customer's packaging needs but also designing and producing a package for the most effective display of the customer's product.

F.

34. The operations of CCA can be divided into two broad categories, the manufacture of paperboard and the production of packaging material from paperboard.

1. *Paperboard*

(a) General

35. Paperboard is one of two principal products of the paper industry, the other being paper itself. The differences between paper and paperboard are in weight, thickness and rigidity. Paperboard is at least 0.012 inches thick and is heavier and more rigid than paper. Paperboard accounts for nearly half of the total tonnage of all paper and paperboard produced. About 85% of all paperboard produced is used for making shipping containers, folding cartons, set up boxes, and other packaging products. The remainder goes to a variety of such end products as plasterboard, wallboard, playing cards, tags and cardboard.

(b) Raw Materials and Production

36. The principal raw materials used by CCA in the manufacture of paperboard were pulpwood and waste paper. Pulpwood was converted into kraft containerboard in CCA mills in Alabama and Florida. ("Kraft" refers to a type of paperboard made of virtually pure, long virgin fibers.) In approximately 10 other CCA paperboard mills, combinations of pulpwood and waste paper were used to produce the various grades of paperboard described below. Paperboard was then converted at the approximately 40 fabricating plants into shipping containers, folding cartons, fibre cans, and other paperboard products described below. Some paperboard produced in CCA mills was sold to third parties, but approximately 90% was used for CCA's packaging operations. Approximately 85% of CCA's pulpwood requirements were obtained from outside sources. The remainder was from timberlands which

CCA owned or held under long term leases. CCA purchased its requirements of waste paper. It also purchased a relatively small portion of its requirements of paperboard, primarily on a long term basis. Other materials, including pulpwood, were purchased in the open market.

(c) Containerboard

37. Containerboard was the largest grade of paperboard produced. It accounted for approximately 63% of total board production. It is a versatile and relatively inexpensive packaging material consisting of a fluted sheet (corrugating medium) glued between two liners. The linerboard which makes up the liners accounted for 71% of containerboard production, the corrugating medium for 28% and filler and other chip board for the balance.

(d) Boxboard

38. Boxboard is the second largest grade of paperboard produced.

(1)

39. Folding or bending boxboard is used almost exclusively in the manufacture of folding cartons. It is strong enough to permit scoring (making a crease for folding) and folding and has good surface properties for printing.

(2)

40. Foodboard, another type of boxboard, is used exclusively to manufacture such containers as milk cartons and dairy containers and such related disposable products as cups and dishes. Almost all foodboard is made from bleached or semi-bleached pulp. Most foodboard is sized

for water resistance and coated for barrier properties or improved printing surfaces.

(3)

41. Set up or nonbending boxboard is the paperboard used in manufacturing rigid paperboard boxes. Its primary properties are exceptional stiffness, rigidity and resistance to abuse.

(e)

42. CCA also produced a special paperboard which was used in the production of a variety of products including fiber cans, drums, tubes and cores, and office and business supplies such as index cards, postcards and file folders.

2. *Production of Packaging Material*

(a) General

43. CCA's products are used extensively in the packaging and shipping of food products, canned goods, clothing, soaps, beverages, furniture, automotive products and accessories, petroleum products, chemicals, electrical equipment, household equipment, textiles, drugs, tobacco and many other products. The primary types of containers used in packaging are briefly described below.

(b) Corrugated Containers

(1)

44. Corrugated containers are exceedingly versatile packages. This container carries such diverse cargoes as nuts and bolts, bathtubs, household appliances, bulk loads weighing a ton or more, frozen berries, fresh iced poultry, artificial flowers, frozen eggs, etc.

(2)

45. There are more than 1,300 plants producing corrugated boxes in the United States operated by over 700 companies.

(3)

46. Corrugated paperboard consists of a fluted or wavy sheet glued to one or more liners. The most common construction is a sheet of corrugating medium sandwiched between two liners (double-faced board); however, a wide variety of combinations is possible depending on the packaging requirements. If a high degree of flexibility in cushioning is needed, only a single facing or liner is used. Where great strength and rigidity are required for heavy loads, three sheets of medium can be combined with the appropriate liners. The resultant construction is designed to meet the size and weight requirements of the container contents. The ability of a corrugated box to provide adequate protection for a particular product under normal handling and shipping conditions is measured and checked through use of various tests.

(4)

47. The basic raw material for corrugated containers is paperboard. Paperboard arrives at a container plant in huge rolls, up to 9 feet in width, 60 inches in diameter, some weighing up to 2½ tons. The container plant normally maintains a large inventory of these rolls which vary by width and weight. The differences in weight make possible several combinations to provide for special characteristics and to meet the various strength tests of corrugated board.

(5)

48. The basic machine in a corrugated container plant is the corrugator, measuring almost a city block. It is a very expensive machine to buy, install, house and operate. Usually three rolls of containerboard are threaded into the corrugator. One liner and one corrugating medium are fed into a "single facer" which bonds them together in a single faced sheet. The single faced sheet then is processed through the "double backer" which applies the second liner, thus forming single wall (double-faced) board, that is, board with one corrugating medium sandwiched between two liners. Gluing an additional corrugated medium and liner to the single wall board forms double wall board. Adding still another corrugated medium and liner produces triple wall board. After passing through a dryer section, which sets adhesive and removes excess moisture, the combined board is given its initial scoring and is cut to size forming box blanks.

(6)

49. The initial scoring and cutting on the corrugator and the finishing operations which follow reflect the fact that each order for boxes is "tailor made" to fit the product or combination of products it will protect and to fit the distribution needs of the user. Finishing may involve cutting slots to form flaps or flanges, printing a simple identification of the contents, and forming the blank box into a container. The product is a "basic brown" box

or container, which is in wide use where utility rather than appearance is the prime consideration.

(7)

50. From this point on the container can be made as attractive or sophisticated as the user requires. It may be printed in multicolors. It may be coated or impregnated with plastic resins or wax to impart certain properties, and may be given non-skid characteristics. The box design may include such features as die cuts, hand holes or an easy opening device. Grease resistant or release properties may be added. Special design features may allow the box to be converted into a display stand or a carry home pack.

(8)

51. The finished knocked-down container is now ready to be bundled, unitized (means by which knocked-down containers are bonded to a pallet), or otherwise prepared for delivery to the user. If inner packing pieces form a part of the complete shipping container, they will ordinarily be delivered with the containers. Because the finished containers are typically shipped knocked-down, they require a minimum of storage space in the user's plant. When needed, they are then set up, packed either manually or on high speed automatic equipment, and closed.

(c) Folding Paperboard Cartons

(1)

52. Another large segment of the paperboard industry is represented by folding cartons which are the basic paperboard package for consumer products sold in supermarkets, drug stores and other retail outlets. These cartons are precision-made, low-cost packages supplied in knocked-down form. When erected they become three di-

mensional rigid packages that meet the requirements of packagers, distributors and end users. They can be handled by high speed automatic packaging machinery for companies operating on mass distribution scale (frequently at speeds exceeding 500 cartons per minute), by semi-automatic or hand-operated equipment, or by hand for smaller production and limited distribution. They lend themselves to progressive marketing and retailing methods and readily adapt to the changing needs of customers.

(2)

53. Typically these containers are printed, cut, creased, folded and often glued by CCA and shipped collapsed to the user. They are not erected until needed. These cartons help assure uniform quality and measure of the product packaged, carry the product's name and its manufacturing trademark, provide a tie-in with product advertising, serve as a product display and can promote point-of-purchase sales. They also offer many convenience features, such as easy opening, carrying handles and dispensing devices.

(3)

54. Packaged food products account for nearly half of these containers. Beverage carriers, soap, hardware and appliances, tobacco, toys, sporting goods, paper goods, and other retail uses account for most of the remainder.

(d) Composite Cans

55. The composite can involves the utilization of various materials combined in minimum but sufficient thicknesses to contain and protect a given product. Multiple

webs permit the placement of thin, high cost materials only where they are actually required in the construction, and permit relatively low cost materials, such as paperboards, to build strength and rigidity. These cans compete primarily with metal cans, approaching them in strength and durability, but generally are lighter weight and less expensive. Major markets for composite cans are motor oil, antifreeze, refrigerated dough products, frozen concentrated fruit juices, cleansers, sealing and adhesive compounds, and snack items. The composite can body or sidewall is made from heavy kraft papers in combination with other materials such as aluminum foil and plastics. Special chipboard with a high reprocessed kraft content and some foodboards are also used. The ends of these containers are composed of other materials—metal or plastics—to produce a composite container.

G.

1.

56. CCA engages in extensive product research, design and marketing research activities to create new effective packages for consumer markets. These activities are concerned with the development of new uses, improved design and more effective marketing of paperboard and plastic packaging. During the years at issue, approximately 250 people were directly involved in these activities at an annual cost of approximately $4.3-5.5 million.

2.

57. Container's Design and Market Research Laboratory, which is based at Carol Stream, Illinois, and has branches located near CCA's largest markets throughout

the United States, has earned a national reputation for its ability to perform a broad range of marketing services for its clients. These services include, among others, the assessment and development of corporate identity and marketing programs, promotional analysis and design, photography, film making, and a complete array of consumer and industrial market research services including product and package testing, consumer interviews, motivation and behavior studies, distribution studies, new product research, retail sale studies, market definitions and profiles, dealer, distributor and retail surveys. While the Design Laboratory does perform a great number of independent services, its primary responsibility is to combine its experience in market research and graphic design with the technical services of the plants and division research and development departments, in an attempt to develop "total packaging systems which function as partners to the products which they contain" instead of as advertisements pasted onto a package. Most design services performed for local accounts are handled through the Design Laboratory branch nearest the client's base of operations.

H.

58. CCA products are made only in response to a specific order by a customer. As a result, CCA does not build up an inventory of finished products as a typical business would do. CCA does have a costing manual which provides a guideline for the pricing of standard packaging designs, even though custom-made products are involved. In determining the price to be charged for a particular product, the local plant manager uses his costing manual as a basis.

plants within a single division and reported to one of three division executive vice presidents. Each vice president coordinated the activities of the plants within his geographical region, reviewed and compiled the capital requests and profit plans and had overall responsibility for each plant in this region. These men would often work with their general managers where problems arose and would work with the executive vice presidents who coordinated the operations of the entire division.

VI

ACTIVITIES OF FOREIGN SUBSIDIARIES—GENERAL

A.

61. During these years the foreign subsidiaries actively engaged in business in 6 countries, three in Latin America (Colombia, Venezuela and Mexico plus a non-operating holding company in Panama with no payroll or sales) and three in Europe (Germany, Italy and The Netherlands plus an inactive company in Austria with no payroll or sales). The Latin American subsidiaries were fully integrated, self-sustaining operational units, each obtaining to the fullest extent possible its own raw materials (local pulpwood or waste paper) within the country in which it operated and then manufacturing and selling its own packaging products designed for the local market.

B.

62. Carton International, S.A. was a non-operating holding company which held interests in Cartotechnica

Europa Carton (Italy) and eight of the Latin American subsidiaries of CCA. Carton Internacional, S.A. was formed in 1944 when CCA was initially contemplating acquisition or establishment of subsidiaries in the Latin American market. Since this type of activity would be uncommon for the paper industry, substantially riskier than domestic ventures and entail operation in political and economic climates significantly different from those to which CCA was accustomed, it was decided that any involvement would be handled through an intermediary. The non-operating holding company incorporated in Panama was designed to accomplish four basic purposes: (1) insulate CCA from shareholder liability and amenability to suit in case of possible expropriation, or contract or tort liability; (2) downplay the involvement of a U.S. corporation in the Latin American countries; (3) prevent U.S. taxation of dividends which were to be invested directly back into one of the Latin American companies; and (4) provide for the possibility that the capital needs and risks of foreign ventures may be too great, by creating a convenient means of transferring ownership of the international operations.

C.

63. Although in various countries separate subsidiaries may have performed different functions in the manufacturing and converting process, the subsidiaries in each country operated as an integrated unit. In each country with a number of CCA subsidiaries, there is generally one dominant subsidiary. This subsidiary, which is usually larger than, and often owns stock in, the remaining sub-

sidiaries, will coordinate the operations of the other subsidiaries in that country.

D.

64. All sales of finished products were made within the country where they were produced by the foreign subsidiaries except that a very small percentage of the production of the foreign subsidiaries is exported to neighboring foreign countries. The sales operations within each country were performed as a part of the total operation within that country. No sales of finished or unfinished products were made by the foreign subsidiaries to CCA or to any customer in the United States. The foreign subsidiaries did make sales in their respective countries to foreign subsidiaries or foreign operations of U.S. companies. Such customers included Colgate, Proctor & Gamble, and the producers of Kleenex, Viceroy Cigarettes, Oster, Pepsodent and Johnnie Walker. The foreign subsidiaries did not sell any products manufactured by CCA. CCA did not advertise in the foreign countries. The foreign subsidiaries performed all their own advertising and solicitation and did not advertise in the United States.

E.

1.

65. The products of the foreign subsidiaries were designed specifically for the local market; a significant part of the work of the foreign subsidiaries in each country was to design products for their local market. There were no joint marketing efforts between CCA and these foreign subsidiaries. Officers of CCA and of the foreign subsidi-

aries, who are familiar with the marketing operations of CCA and of the foreign subsidiaries, if called as witnesses in this action, would testify in their opinion that customers in the foreign countries generally relied upon the reputation developed by the subsidiaries operating in that country and not upon the reputation of CCA. There was no formal procedure or practice by which a subsidiary would request CCA's assistance in the securing of a customer. Due to the unique packaging requirements for products sold in different countries, there was little coordination in this portion of the purchasing function of commonly owned United States and foreign customers. However, where a customer is pleased with CCA's service and products, it may very well wish to use an affiliate of CCA in filling its overseas packaging needs. There have been instances where domestic customers have asked CCA to recommend packaging companies in other countries. In those instances CCA has recommended its own subsidiary where one operates in the applicable market. Absent a specific request, however, sales personnel in the United States or any other country do not make a habit of mentioning foreign affiliations. There was no instance in which CCA and its foreign subsidiaries operated under a master contract. However, there has been at least one instance where CCA did assist in the negotiation of a contract for a foreign subsidiary for the production of banana boxes, a product not produced by CCA. The foreign subsidiaries' market research was entirely independent from the market research conducted by CCA; however, CCA would provide assistance under technical services agreements upon request by a foreign subsidiary. The packaging-related research required for

the products, distribution methods and consumers' habits and preferences in a particular foreign country, was markedly different from that found in the United States market.

2.

66. During the 1964-1965 period, there were design laboratories based at the following locations: Cali, Colombia; Caracas, Venezuela; Mexico City, Mexico; Hamburg, Germany and Milan, Italy. In addition, there was a small structural and graphic design department in Soest, Holland which performed only basic in-plant work for the Dutch subsidiary. There has been very little interaction between the design laboratories of each country. An exception is in Europe, where Europa Carton had a sophisticated design and market research facility which operated as a profit center and consulted all over Europe (including some work for CCA's other European subsidiaries). CCA's Design Laboratory does no market research, structural or graphic design for its subsidiaries nor does it have any direct contact with any of the subsidiaries' clients or customers, except that during these years, and for a few years thereafter, CCA's Design Laboratory did some design work for the Mexican subsidiaries. However, there would always be an employee at CCA's Carol Stream Design Lab who could suggest the use of market research techniques and recommend general problem solving procedures upon specific request by foreign subsidiaries. Also, where a subsidiary was working on a specific product and requested samples of these packages (as designed by CCA or any other domestic company) they would be sent to the subsidiary.

This type of assistance is required by the technical service agreements, for which the subsidiaries pay monthly fees. If a subsidiary decides to establish a new design laboratory, or expand the functions of an existing facility, CCA will provide assistance, but only if requested. There was no organized program to establish facilities in the different countries. Some affiliates already had established design functions when CCA acquired them; others still do not have formal design laboratories.

3.

67. As a practical matter, for companies which are marketing-oriented, such as CCA and the foreign subsidiaries, no meaningful consultation can be conducted between designers of different countries with regard to specific designs. Each country, and in fact each cultural group within a country, has its own individual character and it is this individual character which inspires the purchasing behavior of the group. Since the background of each group is different, their reaction to certain stimuli differs, and the marketing program designed for one cultural group cannot be transposed to another. However, when a subsidiary requested CCA's assistance, suggestions were given as to the use of market research techniques and recommendations were given regarding general problem solving procedures.

4.

68. In determining the relevant markets and the merchandising techniques most effective in each country, a number of factors must be taken into consideration: the state

of the economy, the degree of socio-economic stratification, the cultural background and aspirations of the people in each strata, the behavioral tendencies of the members of each strata when confronted by different stimuli, and so forth. This means that the graphic designers and market analysts charged with the development of a packaging system for a specific country and sub-group must be intimately acquainted with these factors. These varying characteristics mandate different marketing approaches for each country and therefore minimize the value of common design themes. For example, the great social and cultural differences among groups in Colombia combined with the high illiteracy rate and low income, encourage development of basic low cost packages which tend to rely on intense bold colors and typography, and daring color combinations to the low income urban dwellers. The same basic package and design characteristics can be used to appeal to low income farm dwellers, but the advertising theme may be wholly inappropriate. Indeed, in many instances these low income farm dwellers will obtain needed goods either by barter or in a local market. Formalized packaging will have no role in these transactions. Completely different structural and graphic design characteristics and themes may be needed to successfully market to the upper class urban dweller. The packaging approach in Italy must also distinguish between the rural dweller, the urban factory worker and the upper class elite. The rich cultural heritage and high aesthetic consciousness in Italy, however, dictate the use of graphics which are generally more subtle and sophisticated than those used in the U.S.

5.

69. The multiplicity of designs used in each of these foreign countries is anathema to the mass marketing approach in the United States, which generally attempts to amalgamate the entire population into a single market. This approach is feasible in the United States due to the high literacy rate, the high disposable per capita income, the relative cultural unity brought about by mass communication and transportation and the fading class distinctions which are so conspicuous in many other countries.

F.

70. The relative size of particular orders is markedly smaller in the foreign subsidiaries than in CCA. One consequence of this is that certain machinery used by CCA such as the rotogravure printer is not used in the foreign subsidiaries because its high cost can only be justified by high volume orders. The Latin American market for containers and folding cartons was primarily for prime necessities which required packaging with much less complicated inner-packaging than is typical of what CCA produced. Packaging was simpler in part for economic reasons and because the range of products to be packaged was not so diverse as in the U.S.

G.

71. No figures are available to show the relative market shares in a particular country of the foreign subsidiaries located in that country. However, those figures for 1974 are as follows (no figures are available for Germany because that subsidiary was sold by CCA in 1967). Most of

the foreign market sales figures would have been substantially higher in the years at issue:

1974 Market Shares of CCA and the Foreign Subsidiaries in Their Respective Countries

	Container Board	Box Board	Corrugated Containers	Folding Cartons	Composite Cans
U.S.	5.55	6.09	6.26	10.60	17.91
Colombia	(77% of all paperboard)		80.	25.	53.
Mexico	15.	27.	14.	22.	
Venezuela		80.	50.	30.	
Holland	—	—	7.	—	—
Italy	1.4	0.	3.5	6.	—

H.

1.

72. Pricing is established locally by the foreign subsidiaries. No pricing instructions or arrangements are made with or through CCA. There is no pricing manual utilized by the foreign subsidiaries tied in with CCA pricing. CCA has a costing manual. This is a guideline which allows plants to determine what price must be charged on a product to cover fixed and variable costs (based on such factors as grade and quality of materials used, amount of waste, required man and machine hours, etc.). When the plant management is aware of how much it costs to produce a container, it must decide what price it should charge a specific customer based on a number of purely local considerations such as: local market conditions, the importance of the customer, prices previously quoted to the customer, the percentage of capacity at which the plant is operating and numerous others. Each plant must decide for each order, the amount of markup it should

require, whether it is sufficient to break even or whether it should absorb a loss in order to obtain or retain a customer. None of the foreign subsidiaries can use this manual since raw material grades and costs and relative capital and labor intensiveness vary so greatly from country to country. Some subs have developed their own manuals; others have not.

2.

73. Due to the numerous factors involved in each calculation, CCA's costing manual may be used for custom-made as well as "standard" products. A product may be considered "standard" however only to the extent that its basic structure follows a common design (for example, one of the 26 designs listed in the "Handbook For Corrugated and Solid Fibreboard Boxes and Products" which is published by the Fibre Box Association). All products are custom-made, however, to the extent that such characteristics as: board type, basis weight, fluting, board combination, size, coating, innerpacking and graphics must be determined with regard to the particular qualities of each product and the needs of each customer.

I.

74. The management of the foreign subsidiaries was comprised predominantly of local citizens. These management personnel had complete authority and control over day-to-day business decisions. Most major policy matters were initiated by the foreign subsidiary but were generally subject to review by the subsidiary's parent, CCA. The major policy matters consisted exclusively of capital

appropriations. For example, when local plant management decided a new piece of equipment was necessary to meet anticipated future demand, to produce a new product line, to replace obsolete equipment, or for whatever other reason, the plant controller would prepare a formal evaluation of the proposed capital project. This evaluation would include such information as a description and reason for the project, practical alternatives, cost of the project, expected profit, payout and return on investment. After review by the plant general manager, this would be presented to the appropriate divisional manager of the subsidiary and in turn to the subsidiaries' Management Committee and Board for provisional approval. Upon approval, the evaluations are sent to Chicago where they are reviewed by the relevant members of the CCA "Overseas Division" (i.e., the Vice President and Controller), then submitted to CCA's Management Committee and Board of Directors for approval. CCA's reviews and approvals were required and could result in disapproval or major modifications, but seldom did. Final approval must then be given by the Board of the relevant subsidiary. (Prior to actual initiation of the project, local management must determine whether or not they will proceed).

J.

75. The books and records of the foreign subsidiaries are kept in accordance with the generally accepted accounting principles, if any, of the country in which the subsidiary is located. These accounting principles may vary in material respects from generally accepted accounting principles in the United States.

76. Except for the differences noted elsewhere in this stipulation, the machinery, products (in terms of structural design), materials and manufacturing processes used by the subsidiaries were generally comparable to those used by CCA and by other paperboard manufacturers and packagers throughout the world.

VII.

ACTIVITIES OF FOREIGN SUBSIDIARIES— BY COUNTRY

A.

Colombia

1.

Development of Carton de Colombia, S.A.

(a)

77. Toward the end of World War II, James V. Forrestal, then Secretary of the Navy, asked American industrial leaders for advice in coping with what he perceived to be a problem: the burgeoning packaging needs in postwar international trade. The President of CCA, Walter Paepcke, a personal friend of Forrestal, suggested some kind of joint action with the countries of Latin America in order to free them of their traditional reliance on foreign sources for basic materials, in this case packaging materials. Forrestal encouraged this approach.

(b)

78. After investigation, discussions and negotiations, an agreement was formalized and Carton was incorporated in Medellin, Colombia on May 4, 1944. It was financed jointly by Colombian investors and the newly formed

Carton International, S.A., CCA's Panamanian holding company. Carton International and the Colombian group each owned 50% (each putting up 50% of the capital) and the Colombian investors were entitled to name three of the company's five directors. Many of the initial details regarding the formation and operations of the company were governed by a "gentlemen's agreement" in which it was agreed that decisions would be reached by mutual understanding rather than by domination of one party over another, and that the Colombian group would direct legal work, develop personnel and undertake the sales effort, while CCA would manage the technical and financial aspects of the business. Since very little of the necessary equipment was available in Colombia, most of it was imported from the United States, and some of it directly from CCA. CCA personnel did work with Colombians and outside experts in the assembly and start-up of much of the equipment.

(c)

79. Although Carton did have a readily available labor supply, native personnel had to be trained to assume major production responsibilities. Certain key individuals were sent to the United States to study manufacturing practices in CCA plants, and some CCA employees and outside experts served as a complement to Colombian personnel for the first few years. All personnel training was, however, based on CCA's philosophy of developing nationals for any job of responsibility. In addition to CCA's initial involvement with technology and personnel training, it also supplied a portion of Carton's raw material requirements.

were conducted to find ways to reduce Carton's dependence on outside sources for basic materials, especially to reduce the imported paper for the production of bags. In 1953 pulping and refining equipment was installed in a new mill built for this purpose. Additional efforts led in 1959 to the installation of additional pulping and refining equipment to make paperboard from the native hardwood trees which, as described at paragraph 2(b) below, differed significantly from the trees used for pulp grown in the United States.

2.

Materials

(a)

83. During 1963-1965 the operations in Colombia were fully integrated with approximately 2 paperboard mills, 4 container plants and 1 folding carton plant. The raw materials for these mills were a combination of locally manufactured pulpwood and waste paper supplemented to some extent by imported pulpwood and waste paper. Some of the pulpwood and waste paper was imported from various countries, including the United States; the amount imported from CCA was nominal.

(b)

84. The content of the raw materials differed from that typically found in CCA materials, largely because tropical hardwoods were the only available natural resource. There were no tropical hardwoods in the United States. The use of tropical hardwoods as raw material for pulp required different techniques for converting it into pulp and for converting the pulp into paperboard. These techniques

were (and are) not in use in the United States. Most of the mechanical and chemical engineering work was done by Carton employees or by consultants from Forest Products Laboratories of Madison, Wisconsin ("Forest Products") a company not affiliated with CCA. Because of the hardwoods, certain equipment was specifically modified from typical paperboard manufacturing equipment; this equipment was constructed by a British Columbian engineering firm not affiliated with CCA. Not only were there the natural differences between hardwood trees and softwood trees, but there were no available homogeneous forests of a particular species of tree as existed naturally in the United States; instead an average of approximately 150-200 species of trees existed in every jungle area. For this reason the mix of fibers was substantially variegated which required different techniques in order to convert the wood into pulp. In addition, the hardwood jungle forests presented unique problems for moving the product out of the jungle. Often the trees were in the middle of swamps and, unlike tree cutting in the U.S., roads to the place of cutting did not exist. The trees were generally brought out "on-line" which means they were carried out by a line over the top of the jungle until reaching a passable road or waterway. Even upon reaching a waterway the problems were different from those generally existing in the United States because hardwoods would not float and therefore had to be moved downstream by barge.

(c)

85. In addition to the harvesting difficulties described in the preceding paragraph the tropical hardwoods required

a longer cooking process resulting in a fibre which was weaker and more brittle. In addition, there were different temperature and pressure requirements in the digesters, the woods were very dense and difficult to penetrate, and they often had exotic mineral incrustations. Most of the testing done to determine the optimum temperature, pressure, etc. requirements was done by Forest Products.

3.

Products

(a)

86. It is probable that the Colombian subsidiaries used few, if any, formulae, developed by CCA for producing paperboard or other products, nor dies developed by CCA for cutting products or printing on them. Upon request, CCA would send information to a subsidiary. Where the subsidiary wishes to adopt for its own use, a very basic die or formula based on this information, they would probably do so without further consultation. In these instances, CCA would not necessarily know whether or not the die or formula were being used by the subsidiary. These subsidiaries use the metric measuring system which presented many difficulties in the use of American machinery and specifications. Furthermore the products were substantially inferior to those produced by CCA. The use of shorter, less resilient fibers resulted in a product with a burst level (i.e., the specification which measures properties such as tensile strength, tear, stiffness, rigidity, etc.) for the equivalent basis weight which was far too low to meet the rigid American standards for packaging.

(b)

87. Approximately two-thirds of the products of these subsidiaries represented relatively standard (in terms of structural design) products which are similar to those made by CCA and other packagers in the United States and around the world; however, there were also numerous unique products produced by the subsidiaries. Perhaps the most significant product unique to the subsidiaries was a corrugated container for exporting bananas, which resulted in an entirely new concept in the packaging and distribution of bananas and led to a sharp reduction in shipping weight and spoilage. These subsidiaries also produced a multi-wall bag which is not manufactured by CCA. These two products accounted for about 15 percent of these subsidiaries' gross sales.

4.

Marketing

88. These subsidiaries had their own marketing departments which operated completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. While there were common customers between these subsidiaries and CCA, the only other major sources of packaging products in Colombia were one other folding carton producer and one other multiwall bag producer; thus U.S. companies operating in Colombia (or through their subsidiaries) had very limited selection as to where they would purchase their packaging products.

5.

Personnel

89. Approximately 1500 persons were employed by the Colombian subsidiaries. The personnel department worked completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. However, when the personnel department was unable to find qualified individuals in Colombia, it might consult or use the services of CCA's personnel department to locate appropriate personnel.

6.

Independent Stock Ownership

90. The 33⅓% of the stock not owned by CCA was publicly held by Colombian nationals and traded on a local exchange.

B.

Venezuela

1.

Materials

91. The operations in Venezuela were fully integrated with approximately two paperboard mills, three shipping container plants and one folding carton plant. Ninety percent (90%) of the waste paper needs were supplied by local sources. The remaining ten percent (10%) came largely from other Latin American countries and the Caribbean. Less than one percent may have come from the United States; in such cases, it would not have been pur-

chased from CCA but CCA would probably have acted as a procuring agent for the foreign subsidiary. All pulpwood requirements were imported from Canada, United States, and Europe; none was imported from CCA. Pulpwood accounts for approximately 10% of the necessary raw materials. Approximately 93% of the paperboard requirements for container plants was produced locally; the remaining 7% was imported from CCA mills and other sources. The price paid was competitive with what CCA charged third parties. All of the paperboard production of the mill was consumed by the container plants in Venezuela. All of the boxboard requirements for folding cartons were produced locally by their own mill.

2.

Products

92. It is probable that these foreign subsidiaries used few, if any, formulae, manuals, cutting or printing dies developed by or produced by CCA. Upon request, CCA would send information to a subsidiary. Where the subsidiary wishes to adopt for its own use a very basic die or formula based on this information, they would probably do so without further consultation. In these instances, CCA would not necessarily know whether or not the die or formula was being used by the subsidiary. Venezuelan subsidiaries used the metric measuring system. The products were substantially inferior to those produced by CCA. There were no governmental regulations which governed specifications for shipping containers comparable to those which existed in the United States.

3.

Marketing

93. These subsidiaries had their own marketing department which operated completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. Marketing in Venezuela included research, design, advertising and public relations. Marketing departments at CCA operated as separate overhead centers, whereas in Venezuela marketing is one of the staff functions of the manufacturing operations. As indicated at paragraph VI.G. above, the rigorous competition in the paperboard and packaging industry which existed in the United States did not exist in Venezuela.

4.

Personnel

(a)

94. 1,464 persons were employed by Venezuelan subsidiaries. Each subsidiary had its own Board of Directors, the membership of which was divided equally between Venezuelans and CCA officers. Russell Wilson worked for CCA for approximately 6 years, during which time he held various positions in the production area (Trainee, Technical Superintendent, General Supervisor). He transferred to Union Grafica in Venezuela in 1962, and continued working in the production and general management areas until 1967 when he became Director of the newly formed marketing operation. He had no prior experience in this area with either CCA or Union Grafica.

(b)

95. The personnel department worked completely independently from CCA except to the extent, if any, that its contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. However, when the personnel department was unable to find qualified individuals in Venezuela, it might consult or use the services of CCA's personnel department to locate appropriate personnel. In general, key personnel were hired and trained locally. For many years, including those at issue, Venezuela had by regulation limited employment of non-nationals in a company to less than approximately 25% of the total number of employees. These regulations have subsequently been revised to impose such restrictions not only as a percentage of the number of employees but also as a percentage of salary, by geographic district of employment and by company.

C.

Mexico

1.

Materials

(a)

96. The operations in Mexico were fully-integrated with 2 paperboard mills, 1 shipping container plant and 1 folding carton plant. The entire paperboard line and packaging line was made from predominantly local materials: waste paper and mixed waste woods, the latter material not being used by CCA or any of the other foreign subsidiaries. Occasionally shortages were made up by importing these

fibers when necessary, although raw material imports would have been extremely small because of rigid import restrictions. For example, in 1965 CCA procured for Carton y Papel $1,964 of waste paper, representing less than one-tenth of one percent (.1%) of that company's cost of goods sold. Other raw materials used were practically all Mexican made.

(b)

97. In the paperboard mills the process used to produce the paperboard was different from the process typically used by CCA in that this subsidiary produced a modified soda-sulphate kraft pulp in a batch process with two small locally-made digestors. This process is not compatible with large-scale production or chemical recovery. The resulting product was not the same in yield or fibre strength as would be produced by the conventional kraft process utilized by CCA.

(c)

98. The subsidiary's corrugating medium was produced from a combination of waste paper and straw pulp. The straw pulp is made in rotary ball digestors. The use of straw in the pulping process was not used by CCA, except to a very limited extent.

(d)

99. Virtually all of the paperboard requirements for container plants were produced locally. All of the paperboard production of the mill was consumed by the container plants in Mexico.

2.

Products

(a)

100. The corrugated plants used essentially the same machinery and processes as the CCA plants for the standard container line.

(b)

101. The folding carton plant differed from CCA, in that it manufactured its own offset printing plates and did all its own photographic work.

(c)

102. Composite cans were manufactured on the same kinds of equipment as that used by CCA, but generally with less automation. Many paper cylindrical cans were produced for rolled oatmeal, an important line which CCA did not produce at all. This subsidiary also had a substantial volume in spiral-wound cores for textiles and tissue papers, which were not then and are not now in the CCA product line. Most of the composite cans manufactured by this subsidiary were not in the CCA product line.

(d)

103. Because of the predominantly waste paper raw material, the subsidiary's liner board is a different product from the typical fourdrinier kraft liner board produced by CCA. It is of a lower quality and a greater weight is required in order to achieve a particular strength. The corrugating medium is made of waste paper and straw pulp and is also a different product from the CCA medium.

The stiffness rating averaged significantly less than the minimum required for a CCA medium. CCA does not use waste paper for liner board because of the inferior quality product which waste paper produces.

3.

Marketing

(a)

104. The subsidiary's research and technical work was mainly in the area of market research. CCA's Design Laboratory did some design work for the Mexican subsidiaries during this period.

(b)

105. Products for the Mexican market were of lower quality and specifications than those produced by CCA. The Mexican products were made from lower quality fibers, had lower quality finishes on the paperboard and possessed lower strength characteristics. The requirements for packaging were also different from those faced by CCA. The Mexican market was primarily for prime necessities requiring packaging with much less complicated innerpackaging and less elaborate printing than was typical of what CCA produced. Packaging was simpler overall in part because the range of products to be packaged was not so diverse as in the United States.

(c)

106. In 1961 the management of Carton y Papel de Mexico decided to upgrade their design activities from a "primitive" problem solving function to a formal Graphics Department which would provide basic design services for the

Folding Carton and Composite Can Divisions. At that time, there were no design schools for packaging and very few corporations which trained people in this field in all of Latin America. When Carton y Papel contacted CCA, Frank Angeles, a designer of the Carol Stream Design Lab, was recommended because of his background and competence. He was Mexican born, Spanish speaking, and had experience with a number of firms. When Angeles transferred to Mexico as Art Director, he remained on the CCA payroll only to keep his benefit programs in force. In less than 10 years, however, when the subsidiary's design activities further developed into a design and market research center Angeles, who had little expertise in this area, left the organization in favor of another independent Mexican firm.

(d)

107. Very little advertising was done by the subsidiaries. The subsidiaries used only Mexican advertising agencies, none of which was used by CCA.

4.

Personnel

(a)

108. The subsidiary was in charge of its own hiring and made very little use of CCA's Personnel Department to fill key jobs. There were infrequent visits of the subsidiary's personnel to CCA installations on a spot basis; generally, the purpose was to see a specific machine or process or to discuss a specific topic with a designated person. Such visits were within the terms of the technical service agreements described in paragraph VIII.F.

(b)

109. The philosophy and practice of the subsidiary has always been to train and advance Mexican nationals to positions of higher responsibility to the extent possible.

D.

Holland

1.

Background

110. This subsidiary was originally founded in 1938 and existed as a completely independent, privately owned Dutch firm until 1958 when it was acquired by CCA. Since that time it has been managed by a Dutch management team, including members of the former management. No former CCA employees were employed by this company although 3 CCA officers are on its Board of Directors. All purchases of raw materials, supplies, machinery, and all other items needed to operate the business have been made by the subsidiary's purchasing department or by its management.

2.

Materials Used for Production

(a)

111. In Holland the subsidiary had no mills for producing paperboard. Consequently, its raw materials were rolls of paperboard and not primary raw materials. There was one corrugated container plant owned by the subsidiary which produced a quality product for the Benelux market. About 60% of the raw materials came from Dutch suppliers; the other 40% was imported from the United States,

3.

Products

115. All the products were designed by the subsidiary's structural and graphic design department and were designed for the Holland, Belgium and West Germany markets. Specifications for the products were based on metric measurements. Approximately one-half of the products were similar to those made by CCA and used in the U.S., for example, the standard corrugated boxes. In addition, there were many specialties which were unique to the Dutch subsidiary such as flower boxes for carnations, chrysanthemums, orchids and other kinds of flowers and boxes coated with paraffin for potted plants. This subsidiary also makes a single faced glassine product. Glassine is a very dense, lightweight, translucent paper such as that used in the packaging of candy. These specialty products were not manufactured by CCA. All of these boxes had to be printed in multicolors and die-cut. These glassine products, which were designed for tomatoes, biscuits and electric bulbs and accounted for approximately 10% of the subsidiary's business, were made of very lightweight single-faced corrugated materials. There was no comparable product made by CCA. In general, the design of the boxes was substantially simpler than that found in the United States.

4.

Marketing

(a)

116. The subsidiary had its own product design and development staff, which concentrated on developing boxes particularly suited for small size volume orders unique to

Holland. Most boxes were designed to be set up or assembled by hand as contrasted with the automated production of boxes and packaging typical of CCA. The subsidiary had its own testing laboratory, its own structural design department and its own graphic design department, all of which were staffed by Dutch nationals.

(b)

117. There are some years in which this subsidiary does no advertising. When it did advertise, the programs were very modest and no direction was provided by CCA, nor was there any similarity or common theme between local advertising and that done by CCA. There were no common advertising agencies.

E.

118. In general no separate information is provided herein with respect to the German and Italian subsidiaries. The German subsidiaries were sold to a Canadian firm in 1967 and CCA has had no operations in Germany since that time. The Italian subsidiaries are small and operated at a net loss for the three years in issue. The information provided with respect to the Holland subsidiary in Section D above is generally applicable to and descriptive of the operations of the German and Italian subsidiaries and the relationship between CCA and these subsidiaries; there are no differences between the manner of operation of the German and Italian subsidiaries from that of the Holland subsidiaries described above which are material to the issues in this case.

VIII

RELATIONSHIP OF CCA TO THE FOREIGN SUBSIDIARIES

A.

Personnel

1.

119. During the years at issue CCA employed approximately 13,400 persons. The foreign subsidiaries employed approximately 6,800 persons. A list of the number of employees of CCA and of each of the subsidiaries is attached as Exhibit K. It is stipulated that these figures are accurate. During the period there were 38 employees on CCA's payroll who were working for the foreign subsidiaries, most of whom were on the payroll of one of the foreign subsidiaries at some time during these years. It is stipulated that the list of employees in Exhibit C, representing the employees on CCA's payroll who were working for the foreign subsidiaries, is accurate. This figure does not include former CCA employees transferred to foreign subsidiaries who were no longer on CCA's payroll. These individuals on CCA's payroll who were working for the foreign subsidiaries were hired by the foreign subsidiaries as permanent employees, not simply for short periods of time. Of the eighteen shown in Exhibit C who were working at one of the foreign subsidiaries in January 1963 half had commenced their employment with the subsidiary in the 1950s. CCA did not have a general policy of transferring employees to foreign subsidiaries. Total payroll of CCA, of the foreign subsidiaries, and the total amounts paid

by CCA for the employees working for a foreign subsidiary were as follows:

Year	Foreign Payroll Paid by CCA	Total CCA U.S. Payroll	Total Foreign Payroll
1963	$443,752	$89,521,641	$12,894,985
1964	381,127	93,974,988	14,301,412
1965	330,057	97,757,998	15,407,405

The foreign payroll paid by CCA constituted approximately 3% of the total foreign payroll. In some instances (up to ten) CCA had no contact with these U.S. citizens prior to their being hired by the subsidiary. For example, some were living in, or traveling through, a foreign country and were hired by a foreign subsidiary. If they were to request partial payment in U.S. dollars CCA would generally oblige. CCA was reimbursed for these amounts by the appropriate foreign subsidiary. Exhibit C indicates whether the individual's responsibility was at the level of a single plant (P), at the level of a division (D) which is a number of plants producing the same commodity within a single corporation (e.g., paper manufacturing, corrugated container production or folding cartons), or at the overall corporate (c) level. The basic plant management structure is as follows:

General Manager

Production Manager Sales Manager Controller

Typically, general managers report to division managers who report to vice-presidents who report to executive vice presidents who report to the president.

2.

(a)

120. Transfers of CCA employees to subsidiaries are generally initiated in only one way; where a subsidiary was unable to fill a specific position locally, it might contact CCA to request assistance in finding a person with specific qualifications. CCA would generally first look within the organization because employees do have some familiarity with the industry and CCA, but more importantly, because this provides a rational basis for determining whether the individual possesses the abilities and personality traits required for success in a new position in a new country. Most former CCA employees remained partially on the CCA payroll when they began working for a foreign subsidiary. Generally, all benefits but membership in the common stock bonus plan were continued. A list of former CCA employees working for the foreign subsidiaries is attached as Exhibit D and it is stipulated that this list is accurate, to the best of CCA's knowledge and belief. It is possible there are other former employees of CCA who might have worked for a foreign subsidiary during these years. CCA believes there are few, if any, other such employees.

(b)

121. Persons who are not long-term residents of the country, whether CCA employees or not, will be selected for a position only in rare instances. From a financial standpoint, the interviewing and moving process is tremendously expensive and the computation and administration of reimbursement is costly and troublesome and

is complicated by such factors as: adjustment for cost of living differentials; the integration of non-complementary and constantly changing tax laws; and the continuation and satisfaction of various domestic benefit programs and outstanding liabilities.

(c)

122. The psychological considerations are even more important. Each individual will have different problems and each position will require different adjustments; there are some problems which are quite common however. Regardless of an individual's previous background in the language of the new country, it commonly takes up to two years before a person can become entirely fluent in the local language and familiar with local idioms, convey subtle differences in meaning and be truly comfortable in meetings. Also, aside from the necessity of learning to adjust to a new business environment, the individual must develop a completely new management style. Local business customs and procedures will often require a great degree of formality, subtlety and an entrepreneurial, seat-of-the-pants approach. In working with subordinates, the manager must learn to deal with employees who have little formal education and are extremely sensitive about their self-image. He must become accustomed to having things done slowly and must develop a tremendous reserve of patience and tact. The greatest adjustments, however, are required in the manager's personal life. It is often quite difficult to adjust to a life with fewer material amenities, cultural outlets and social opportunities. Foreigners are extremely susceptible to exotic diseases; children may have

to attend schools which are abominable by U.S. standards, and where they will always be "different" from classmates; the nonworking spouse will have a hard time meeting friends with similar interests; and in many countries, families will never adjust to the continual danger, where body-guards, guarddogs, high fences with broken glass, bars on windows, and occasional gun turrets, become the way of life.

(d)

123. Even where managers and their families can adjust to the drastically different lifestyle, a company can expect reduced effectiveness for roughly three years. Even after this period, the transplants will seldom integrate into the society, an important objective for any manager.

3.

124. The reasons why some employees of the foreign subsidiaries were on CCA's payroll varied from case to case but generally were for one o following reasons:

(a) These employees preferred to have their checks sent to an American bank due to conversion difficulties in these countries.

(b) Several had life and accident insurance policies, were putting their children through United States schools and/or had other family and personal obligations in the United States and it was more convenient for them to pay their bills through a checking account on a United States bank.

(c) Maintaining a U.S. payroll for these employees facilitated deductions for social security and other retirement benefits. Most former CCA employees remained on the payroll in order to continue all employee benefits, except participation in the common stock bonus plan.

(d) Out of the 38 employees in Exhibit C, seven were granted options under CCA's stock plan of 1956.

4.

125. Maintenance of these foreign employees on CCA's payroll required only minimal effort on the part of CCA's accounting department. CCA was reimbursed for the service (and the payroll costs) by the foreign subsidiaries.

5.

(a)

126. During this period, CCA's foreign operations staff consisted of a part-time senior executive officer, Mr. Green; two full-time officers, Messrs. Ulvaeus and Kaufman; one part-time controller, and one part-time lawyer.

(b)

127. Mr. Green, Senior Vice President of Overseas Operations, spent approximately 40% of his time on overseas work, a portion of which was handling CCA's international legal affairs (the remainder of his time was spent as the Corporation's General Counsel). He made decisions regarding the overseas operations, but due to his limited background (no experience in sales, production or finance), and lack of intimate familiarity with the subsidiaries' affairs (he visited each country only once or twice a year)

his ability to truly manage their business was limited. He had no responsibility for every day administrative duties and did not regularly attend board meetings. With each subsidiary having total responsibility for its own performance, Mr. Green's primary functions were to oversee CCA's foreign subsidiaries and communicate requirements for compliance with CCA's standards for professionalism, profitability and ethical practices.

(c)

128. Lennert Ulvaeus, a native of Sweden who had considerable experience in the European paper industry, began in sales with CCA in 1948. Due to his background in the European market, he transferred to Europa Carton in 1956 and was promoted to Vice President of European Operations in 1963 and chief operating officer of Europa Carton. When the German operations were sold in 1967, Mr. Ulvaeus terminated employment with CCA and went to work for the new owners to manage the same German properties. Mr. Ulvaeus had responsibility for all European subsidiaries which included eighteen plants in 3 countries. Earl Kaufman, who had held a number of positions with CCA since 1933, transferred to Carton de Venezuela in 1954, after the subsidiary had undertaken an expansion program. He was named Vice President of Latin American Operations nine years later. Mr. Kaufman had responsibility for all Latin American operations which included 25 plants in 3 countries. Both of these men were on the payroll of CCA and a foreign subsidiary. To the extent they performed functions for foreign subsidiaries they were compensated by those foreign subsidiaries. Each

acted as steward for CCA's foreign interests, and liaison between the parent and the subsidiaries in their respective locales. Mr. Kaufman and Mr. Ulvaeus (except for Europa Carton of which Mr. Ulvaeus was chief operating officer) did not have responsibility for day to day administration of the subsidiaries, but both men, to an extent, were involved with major problems and long range decisions. Each reported directly to Mr. Green, a senior vice president (which is one step below an executive vice president).

(d)

129. To the extent CCA had to make decisions regarding its foreign subsidiaries, these three men presented studies and made recommendations to CCA's Management Committee and Board of Directors.

(e)

130. To the extent that CCA wished to make its opinions known to the management of the subsidiaries, these three men spoke for CCA. This does not mean, however, that CCA used them as a means of domination. CCA's policy of reaching decisions by mutual understanding rather than domination was strictly observed. Where CCA bought existing operations, especially in Europe, the prior owners generally stayed on to manage the operation for CCA. Due to their past positions, and often fierce loyalty to employees, these men would also refuse to accept domination. In addition, CCA holds local management strictly responsible for its performance. It is impossible to impose this type of responsibility on managers without giving them commensurate authority, if you wish to preserve

morale, and therefore long term performance. There is also the factor of greater government involvement in management decisions such as typically exists in the countries where the foreign subsidiaries operate. Where governments demand a voice in such decisions as plant location, capacity expansion, pricing, worker involvement in corporate decisions, worker retention and wages, the discretion of an owner is greatly reduced. Also, nationalistic governments of less developed countries do not take kindly to having foreign owners of major components of the economy imposing decisions which may or may not be in the best interest of the country.

(f)

131. Attached as Exhibit E is a list of the CCA directors and officers serving as directors or officers of foreign subsidiaries. It is stipulated that this list is accurate. In addition to the three men described above, five other CCA officers held directorships at one or more of the subsidiaries: Messrs. Chrysler, Van der Eb, Guenzel, Meier and Spachner. The first four men held positions at CCA which ranged from Secretary to Executive Vice President, and were never directly involved with the foreign operations. Mr. Spachner, who was Vice-Chairman of the Board of CCA, had been involved, with Mr. Paepcke, in the early planning and administration of the foreign operations. Except for Mr. Spachner, none of these men was familiar enough with the specific circumstances of the subsidiaries for which they were directors, to actively participate in their management, nor did they regularly visit the subsidiaries or attend board meetings although they may have voted by proxy.

5.

132. While there was no United States training program for the foreign subsidiaries' employees, there were during this period approximately 10-12 visits per year for 2-6 week periods by foreign employees to the United States to familiarize themselves with the methods of operation of CCA. These were at the expense of the foreign subsidiary. Most visits were by one person at a time. Occasionally two or three people may have visited at one time. Most of the people who made these trips were those in control functions. Occasionally, plant managers came to the United States to see how CCA plants operate.

B.

Loans

133. Occasionally CCA loaned money to a foreign subsidiary. The total loan advances from CCA outstanding at year end for the years at issue were as follows:

1963	1964	1965
$7,704,987	$7,155,714	$3,223,371

There never have been any loans between foreign operating subsidiaries in different countries. The subsidiaries also borrowed substantial funds locally. The total loan advances from financial institutions for the years at issue at year end were as follows:

Total short-term loans:

1963	1964	1965
$8,034,000	$3,140,000	$2,397,000

Total long-term debt:

1963	1964	1965
$10,562,000	$12,357,000	$12,044,000

Generally, long-term debt has been approximately one-third from United States' sources (loans from CCA and a small amount from U.S. banks) and two-thirds from local sources. Those loans from local sources were generally from: banks, insurance companies, other financial institutions, unrelated corporations, or agencies of foreign governments. Whenever practicable, financing was obtained from local sources in order to minimize the risk of currency fluctuations. For the most part CCA had no involvement in the arrangement of outside loans to the subsidiaries. However, CCA guaranteed approximately one-third of such loans.

C.

Financial Reporting By Subsidiaries

1.

134. During these years there was little profit planning. Long range budgeting consisted of a three-year forecast each year of capital projects supported by forecast balance sheets and cash flow statements. The budgets were submitted to CCA for information but not specific approval. These were usually reviewed by CCA in connection with its annual meeting. Capital projects for each year were reviewed on a quarterly basis by the Container Management Committee and Board of Directors. Final approval of the projects, however, was made by the local boards of directors of the various companies. Funds required for operations and expansions were generated from operations and, when necessary, the foreign subsidiaries borrowed funds on their own. Although there was some review by CCA management of such financing, for the most

country where the subsidiary was located. It would be impossible for Chicago personnel to decipher or analyze a mass of numbers which had no meaning to them. If CCA could not determine a subsidiary's condition by merely reviewing its financial statements, it would have been forced to take a more active role.

D.

Legal and Accounting

1.

138. During the period all international subsidiaries except Holland and Germany were audited by Arthur Andersen & Company as was CCA. Holland was audited by a local Dutch firm. Germany was audited by a local German firm. None of the international subsidiaries used the same law firms as CCA. In all cases the subsidiaries used local law firms. CCA did not use these law firms.

2.

139. Accounting procedures and methods were far from standardized although CCA worked toward achieving the most efficient systems and procedures possible.

3.

140. Tax returns to foreign governments and their subdivisions were prepared and filed locally in each country. The returns were filed taking into account only the applicable income and deductions incurred by the subsidiary or subsidiaries in that country and not taking into account the income and deductions of CCA or the subsidiaries operating in other countries.

E.

Intercompany Sales

1.

141. CCA made sales of linerboard to the foreign subsidiaries of less than one half percent of the total purchases by the subsidiaries. The largest amount of these intercompany sales was to Europa Carton, A.G. These were sales primarily of linerboard in the following amounts, which amounts represent the indicated percentage of Europa Carton's cost of goods sold.

1963	1964	1965
$203,594	$594,487	$733,780
(1.1%)	(2.7%)	(3.0%)

In general, however, Europa Carton purchased linerboard in Europe (mostly Scandinavia) and from Canada. A small percentage of other paperboard or raw material requirements of various subsidiaries was purchased by those subsidiaries from CCA. In all cases the prices paid were the same CCA would charge to other independent purchasers. In all cases those materials could have been obtained from sources other than CCA.

2.

142. One reason for the very limited inter-country sales was because materials used in the paper industry are so bulky and expensive that the cost of transportation was too great in relation to the value of the product. In addition, most of the lesser developed countries severely restricted imports as a means of protecting their foreign exchange.

3.

143. In addition to the intercompany sales, it appears that CCA purchased some paper from third parties which was sent to the foreign subsidiaries. The foreign subsidiaries reimbursed CCA. The amounts of such purchases for the years in suit are not known. For the years 1966-68 the amounts are as follows: 1966—$3,823,946; 1967—$7,357,609; 1968—$6,292,259. CCA assumes that such sales took place in the years in suit but is unable to stipulate that the 1966-1968 figures are typical of the years in suit.

F.

Technical Service Agreements

(1)

144. CCA entered into Technical Service Agreements beginning on the dates indicated with the following foreign subsidiaries, which agreements are attached as Exhibit F.

Bremer Papier Und Wellpappen Fabrik A.G. (10-23-63)
Cartoenvases de Mexico (7-1-63)
Carton y Papel de Mexico (7-1-63)
Industrias Aztlan (9-1-65)
N.V. Mercurius Golfcartonindustrie (10-1-63)
Europa Carton A.G. (10-23-63)

There were no Technical Service Agreements with any of the Colombian or Venezuelan subsidiaries since blanket agreements are not allowed by these countries. CCA did perform services for these subsidiaries, however, and was reimbursed to the extent allowed. While less developed countries frequently restrict payments to foreign affiliates as a means of protecting their foreign exchange, CCA

would make book entries to reflect unrecoverable charges. Since fair market value of many of the services cannot be ascertained, charges are often computed on the basis of an apportionment of the overhead of the relevant staff department.

(2)

145. These agreements provided that CCA would offer advice and consultation to the particular subsidiary concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting. The total fees paid by the subsidiaries, including those paid pursuant to the Technical Services Agreements, were:

1963	$179,985
1964	$591,192
1965	$587,650

(3)

146. The agreements called for payments to CCA for these services based either on fixed amounts per month or a percentage of the subsidiaries' trade sales. CCA did not enter into any agreements this extensive with non-affiliated companies. There were, however, a number of less extensive agreements for technology transfers and some use by non-affiliates of specialized staff services for which they were charged amounts similar to subsidiaries. For example, an agreement might be entered into with a nonaffiliated company to transfer technology related to a specific product such as a composite can. An example is attached as Exhibit G. The subsidiary was completely free to select when it wanted to avail itself of CCA's services pursuant

to the agreement. Expenses of visits by personnel of either CCA to the foreign country or the foreign subsidiary to the United States were borne by the respective subsidiary. The subsidiaries could, and often did, approach other sources (such as local consulting firms) for information which was obtainable from CCA pursuant to technical service agreements. These local firms could be expected to understand some of the subsidiaries' problems better than CCA, which was accustomed to operating in a different environment.

G.

Purchase of Equipment

(1)

147. On some occasions CCA assisted the subsidiaries in their acquisition of equipment and machinery. Some of the used equipment was purchased directly from CCA. In general such equipment could be sold to purchasers other than the foreign subsidiaries and on some occasions used machinery has been sold to competitors of CCA or of the foreign subsidiaries. There was no formal method of notifying the subsidiaries of the availability of this equipment. In the rare instances where a piece of equipment was in good operating condition, but no longer suited to the requirements of the domestic market (i.e., it was no longer competitive due to its low capacity or was designed for a process no longer used domestically), CCA would contact a subsidiary if it was felt there may be a need for such equipment. If the subsidiary's management decided they could use machinery (CCA exerted no pressure), a sale would be arranged. During most of the period at issue, the

subsidiaries were generally charged book value plus the costs incurred in preparing and shipping the equipment. Shortly thereafter CCA used independent appraisers to determine the fair market value. Sales were then made at fair market value plus costs.

(2)

148. CCA's purchasing department also has assisted the foreign subsidiaries' purchase of equipment from independent suppliers. Generally such assistance was limited to purchases from U.S. manufacturers. Approximately 90% of the equipment purchased by the European subsidiaries was purchased from European suppliers and done without the assistance of CCA's purchasing department; approximately 10% of the Latin American subsidiaries' equipment was purchased in the same manner; the remaining 90% was purchased with the assistance of CCA's purchasing department. When CCA's purchasing department was utilized, the subsidiary would perform its own engineering studies and submit its specifications to the purchasing department and CCA would then locate the required machinery and act as an intermediary by ordering, following up and expediting. This "brokerage" function could have been performed by independent brokers, although the commission they would charge would probably be somewhat higher than what CCA charged for the services (generally 5% of the purchase price). CCA occasionally performed this function for unrelated companies. The equipment and parts purchased by CCA and billed to the foreign subsidiaries, as described in this paragraph, amounted to approximately $5-7 million per year.

H.

Miscellaneous

(1)

149. There were no common employee benefit plans, or participation between CCA and any of the foreign subsidiaries. Since 1967, all the subsidiaries have used an affiliate of the same insurance agent as CCA. This was not the case in prior years. Between 1963 and 1966 the Colombian and Venezuelan subsidiaries did use CCA's primary insurance broker. The Mexican subsidiaries did obtain some insurance from the Mexican affiliate of one of CCA's brokers, but generally used the services of a wholly local firm. The European subsidiaries used only local agents who were not affiliated with CCA's broker.

(2)

150. There were no additional intercompany licenses or royalties. Where any material right, property or expertise was provided to a company which did not pay royalties pursuant to an agreement, CCA would generally charge the recipient, whether it was affiliated or not. While similar fees were usually charged to all companies, CCA did not always charge non-affiliates for these services.

(3)

151. The United States Internal Revenue Service has audited CCA for the years in issue and accepted as accurate for United States corporate income tax purposes the net income figures of CCA set forth in Exhibit A (which figures reflect certain adjustments made during the audit). No adjustments to income or deductions pursuant to In-

ternal Revenue Code section 482 were proposed by the Internal Revenue Service.

(4)

152. Attached as Exhibit H is a speech given in 1967 to San Francisco Security Analysts by Leo H. Schoenhofen, then president of CCA.

(5)

153. The Annual Reports of CCA are attached as Exhibit I.

(6)

154. The Forms 2952, which are attached to the federal income tax returns of CCA for the years 1962-1965, as well as certain parts of the tax returns themselves, are attached as Exhibit J. It is stipulated that the figures therein are accurate.

(7)

155. Attached as Exhibit K is a schedule of the number of employees of CCA and of each of the foreign subsidiaries. The parties stipulate that these figures are accurate.

(8)

156. The parties agree that each may refer in oral and written argument to the statutory and administrative law of the foregoing countries in which the subsidiaries are located.

157. The Franchise Tax Board has audited CCA for each year subsequent to 1965, up to 1973, and has followed the same approach as in the years in suit requiring CCA

to file a combined return with its foreign subsidiaries. This combination has resulted in a proposed tax deficiency for each such year.

Dated: February 23, 1978.

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Superior Court of the State of California
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[Title Omitted in Printing]

ADDENDUM TO STIPULATION OF FACTS

The following paragraph is hereby added as paragraph 158 to the Stipulation of Facts herein dated February 23, 1978. Said paragraph is subject to the limitations and reservation of rights described in paragraphs 1 through 7 of the February 23, 1978 Stipulation of Facts.

158. In approximately 1953 a joint venture arrangement was entered into between Institute de Fomento, an agency of the Colombian government, CCA and Carton de Colombia to develop a special pulping process. Each of the participants contributed an equal share of the necessary financing. Most of the work was done by an outside engineering firm. By approximately 1963 Carton de Colom-

bia bought out the interests of the CCA and the Colombian government.

Dated: February 23, 1978.

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[Title Omitted in Printing]

SECOND ADDENDUM TO STIPULATION OF FACTS

[Filed June 29, 1979]

The following paragraphs are hereby added as paragraphs 159-162 to the Stipulation of Facts herein dated February 23, 1978. Said paragraphs are subject to the limitations and reservation of rights described in paragraphs 1 and 3 through 7 of the February 23, 1978 Stipulation of Facts. It is stipulated that Edward F. Buckler, Director of Taxes and Insurance of CCA, would testify as set forth in paragraphs 159-162 if called as a witness. Mr. Buckler has been employed in the tax department of CCA since 1960 and is experienced in working with the financial and tax information supplied by the subsidiaries.

159. The actual net income taxes paid by the following CCA subsidiaries operating in foreign countries to the taxing authorities of such countries for the specified income years are set forth in the table below. For certain of the subsidiaries in certain years (indicated by an asterisk) CCA has been unable to locate from its books and records at this time the actual tax liability paid. However, the forms 2952, attached to the Stipulation of Facts as Exhibit J, show the provisions for tax liabilities of such

subsidiaries for the specific years and those figures are set forth in the table.

	1963	1964	1965
Colombia			
Cellulosa y Papel de Colombia, S.A.	0	0	0
Carton de Colombia, S.A.	2,508,036	2,533,755	1,484,104
Venezuela			
Corrugadora de Carton, S.A.	116,282	158,130	234,542
Carton de Venezuela, S.A.	410,372	808,010	932,257
Union Grafica, S.A.	39,916	67,092	128,115
Cartones Nacionales, S.A.	5,151*	415,211	479,184
Fibras Industriales de Venezuela, S.A.	3,138*	4,583	614*
Cartoenvases Valencia, S.A.(A)	—	—	0
Mexico			
Industrias Aztlan, S.A. de C.V.(B)	—	—	0
Cartoenvases de Mexico, S.A.	951	105,383	62,374
Carton y Papel de Mexico, S.A.	310,153*	690,823	988,412
Italy			
Cartiera Europa Carton, S.p.A.(C)	0*	0	
VOSA, S.p.A.	48,374*	14,390	116,136*
Europa Carton Italiana, S.p.A.	5,162*	1,794	6,927*
Cartotecnica Europa Carton	76,688*	47,551	46,411*
Holland			
N.V. Mercurius Golfkartonindustrie	161,750	199,689	213,483
Germany			
Bremer Papier und Wellpappen Fabrik	249,720	268,504	294,500
Europa Carton, A.G.	283,225*	361,590	1,142,554
Austria			
Europa Carton Austria, A.G.	0*	0	0*

*Figures from Form 2952

(A) Incorporated November 26, 1965

(B) Company acquired in 1965

(C) Company sold in 1964

160. As stated at paragraph 21 of the Stipulation of Facts, the forms 2952 are prepared from the books of the subsidiaries and are computed in accordance with the generally accepted accounting principles of the countries in which the subsidiaries operate. It is the belief of Mr. Buckler and others in CCA's tax department based upon many years of experience in reviewing financial and tax information supplied by the subsidiaries that the provision for tax liability shown on the forms 2952 is generally within 5 percent and not over 10% (either higher or lower) of the actual tax liability shown on the tax return filed by the subsidiaries.

161. The actual tax liability shown on the subsidiary's tax return and the tax liability shown on the forms 2952 are different in some cases because there are some differences in defining net income as between the generally accepted accounting principles of the countries involved and the income tax laws of such countries. Generally tax laws require some differences from financial report accounting.

162. The forms 1118 attached hereto for the years 1963, 1964 and 1965 as Exhibit L are part of the federal income tax returns filed by CCA for those years. The forms 1118 establish the foreign tax credit allowed to CCA in computing its federal income tax liability. Schedule B of the forms supports the foreign tax credit allowed for dividends paid by the subsidiaries to CCA. Column (4) of Schedule B states the net income of the subsidiaries computed in accordance with the income tax principles of the United

States Internal Revenue Code, i.e., the amount is calculated by including the same items of income and deduction permitted under the Internal Revenue Code. Column (5) of Schedule B states the actual income tax liability of the subsidiaries paid for the years in question to the foreign countries in which they operate. The remaining columns (6) through (11) set forth the method for determining the amount of tax paid by each subsidiary to its country of operation which may be credited against CCA's United States income tax liability.

Schedule A of form 1118 sets forth the amount of taxes of CCA withheld and paid by the subsidiaries, and in some cases other corporations, in regard to dividends or other payments made to CCA. These taxes are withheld under the laws of the particular country where the subsidiary or other corporation operates and are generally a stated percentage of the dividends or other payments made. The amounts set forth for taxes paid or accrued in Column (6) (a) of Schedule A are stated in foreign currency. Otherwise the amounts set forth in Schedule A which relate to foreign source income and foreign taxes paid or accrued and set forth in Schedule B and attachments which relate to the foreign subsidiaries' net income, foreign income taxes paid, profits and dividends are restated from local currency to United States dollars. References in Schedule A to Canada, England and Australia are in reference to the receipt by CCA of royalties, fees and dividends from independent companies which were not affiliated with CCA.

Except for the dividends the income involved was included in CCA's unitary income.

Dated: June 29, 1979.

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[Title Omitted in Printing]

No. 673492

[Filed Feb. 23, 1978]

STIPULATION RE TESTIMONY OF THOMAS M. KUCHARVY, HARRY E. GREEN AND WILLIAM P. LEE ("STIPULATION RE TESTIMONY")

IT IS HEREBY STIPULATED by and between plaintiff and defendant, through their respective counsel, that Thomas M. Kucharvy, a lawyer currently employed in the Tax Department of CCA, if called as a witness, would testify as set forth in Exhibit 1 to this Stipulation re Testimony, and that Mr. William P. Lee, who has been an officer of CCA for approximately twenty years and is currently the Assistant Corporate Controller for CCA's International Operations (a position he has held for over ten years, before which time he was Assistant Controller for Domestic Operations for approximately eight years), if called as a witness, would testify as set forth in Exhibit 2 to the Stipulation re Testimony, and that Harry E. Green, a retired officer of CCA who was General Counsel and Senior Vice President of Overseas Operations during the years 1963-1965, if called as a witness, would testify as set forth in Exhibit 3 to this Stipulation re Testimony. The parties agree that this Stipulation is to be treated as if the named individuals testified as set forth in the respective exhibits to this Stipulation re Testimony; provided, however, that this Stipulation re Testimony shall not be construed as a concession by either party of the admissibility on the grounds of relevancy or materiality of such

testimony or such exhibits and the parties hereto expressly reserve the right to argue the admissibility on the grounds of relevancy or materiality of all, or any portion, of such testimony.

Further, with regard to Schedule I-IV of Exhibit I, the parties stipulate that direct costs, income and other data relating to individual plants as determined on a separate accounting basis are accurate. However, the allocation of joint costs between two or more plants, analysis of data and conclusions therefrom represents the position of CCA on this issue. The State of California reserves the right to challenge such allocation of joint costs between two or more plants, analysis of data and accuracy of conclusions therefrom based on the record.

Dated: February 23, 1978.

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EXHIBIT 1
TO STIPULATION
RE TESTIMONY

STATEMENT OF THOMAS M. KUCHARVY RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

Units of Production and Sales

Schedule I compares the fiscal 1974 operating results of all of the California corrugated plants with the results for the Cali, Colombia plant (the only Colombia plant for which information is available). Line 1 shows the number of units (Thousands of Square Feet) produced by each plant during 1974. Line 2 shows the number of units shipped. During 1974 the average U.S. CCA corrugated plant produced approximately 415,000 MSF. The average Colombia plant (excluding two extremely small satellite plants and the large banana box plant) produced approximately 235,000 MSF. While this discrepancy may tend to overstate certain fixed charges per unit of production for the Cali plant vis-a-vis the California plants, this should not be significant since many of the fixed plant charges are a function of the plant's size, and most of the fixed corporate charges are allocated in accordance with the size of the plant.

Sales Price

Line 3 of Schedule 1 shows the average sales price per MSF. While there is little difference between the prices charged by each California plant, Cali's price is 29% higher. This difference can be explained partially by Cali's

higher costs of production and partially by Carton de Colombia's dominant market position (see section VI-G of the Stipulation of Facts in this suit).

Material Costs

Material costs are the purchase prices of all of the paperboard, adhesive, ink, closure materials, coatings, and other miscellaneous supplies which are used in the manufacture of the finished product (it therefore includes scrap materials). As explained in section VII A.2. of the Stipulation of Facts in this suit, Container Corporation and Carton de Colombia used different raw materials. CCA produces most of its linerboard from southern softwood pines through the use of a well known pulping process. This yields a high quality board with good tear, stiffness edge crush and burst strength (this latter characteristic being crucial in the meeting of U.S. shipping standards) per pound of basis weight. The medium which is generally used in the United States is virgin semi-chemical, which is made primarily from specific U.S. hardwoods (e.g., gum or birch). These hardwoods are more difficult to pulp and a combination of mechanical and chemical processes must be used. They yield a hard medium with good compression and flat crush at a low basis weight. A typical combined board may use two sheets of 47 lb. softwood kraft liner with individual burst strengths of 105 lbs. with a sheet of 26 lb. hardwood semi-chemical medium with a flat crush of about 60 lbs. In 1974 the average price of each MSF of this liner cost $4.23 while one 1.5 MSF of the medium (this is the amount needed to produce one MSF of 'C'-flute board assuming a take-up factor of 1.5) cost $3.24. The

paperboard required to produce one MSF of the combined board would have weighed 133 lbs. and would have cost $11.70. This is quite close to the actual average board cost for the California plants. In Colombia, a hardwood liner which would match the burst strength of the 47 lb. softwood kraft would have a basis weight of roughly 75 lbs. and would have cost $12.43 per MSF. Colombian medium which is generally made from wastepaper has a very low compression and flat crush. If the Cali plant were to need a medium which would meet the 60 lb. edge crust of the 26 lb. U.S. medium, it would use tropical hardwood medium having a basis weight of roughly 30 lbs. 1.5 MSF of this board would have cost $7.20. If Cali were to produce a combined board which was to meet the burst strength and flat crush characteristics of the above described U.S. board, it would weigh 195 lbs. (46.6% more than the U.S. board) and cost $32.06 (274% of the U.S. board).

For most situations it is impractical, from both a package weight and cost standpoint, for packages made in, and for use in Colombia, to meet U.S. shipping standards (Colombia has no such standards). Schedule I, Line 3, Column 7, shows that Cali's board cost per MSF of production was $20.56. While this was considerably higher than the U.S. cost, it was well below that required to meet the U.S. board strength characteristics.

Variable Conversion Costs (Schedule I, lines 7-9)

Variable conversion costs consist of such factors as manufacturing labor, cutting and printing dyes, fuel and certain supplies. Manufacturing labor (Schedule I, Line 7)

is the largest factor. It is composed of the hourly labor costs (including benefits and payroll taxes) incurred in the production process.

Each production facility is designed to accomplish a particular task as efficiently as possible; in the case of a corrugated plant, this is to convert paperboard into finished containers. As is the case in most manufacturing operations, this can be accomplished in a number of ways. Each plant is specifically designed in light of the relative availability and cost of each of the resources needed to produce the containers. The most important resources for purposes of this section are machinery and equipment and production employees (the costs of which are the primary components of the property and payroll factors). The relative cost of each of these resources will determine, among other things, the degree of labor and capital intensity of the particular facility. Generally speaking, since U.S. labor costs are high in relation to the cost of equipment, U.S. manufacturers continually strive toward increased mechanization of their production facilities. This situation is reversed in Colombia. Schedule III, which sketches a portion of the production process of a typical California container plant and the Cali plant, helps to explain this point.

After combined board is produced on the corrugator, it must be printed, cut, folded and sealed. In the United States these operations will generally be performed on a flexo-folder-gluer. This machine automatically feeds the corrugated blanks into a printer, makes the necessary cuts and scores, folds the container into its knocked-down form,

and glues it together. At the end of this process, the containers are scanned, the defective ones are ejected, and the acceptable boxes are counted and tied into specific sized bundles—all automatically. These bundles are then transported on an electronic conveyer system to an automatic palletizer (which places the proper number of bundles on each pallet in a preprogrammed format). The pallet is then conveyed to a strapper which automatically secures the bundles to the pallet, and prepares them for shipping. In the U.S., it generally takes 5 people to operate these machines and guide the board through the system. The output, which is primarily determined by the speed of the flexo-folder-gluer, is generally about 8,000 boxes per hour of running time.

The Cali plant is operated completely differently. The combined board is first taken to a letterpress printer-slotter. The printing press, which operates on a wholly different principle and uses a different base ink than the flexographic press described above, is less expensive and requires more labor. The printed, cut and scored board will be manually removed from the machine's hopper, will be hand examined for defects, stacked on a pallet, and be carried by hand cart to the next operation. The folder-gluer will then complete the conversion operation. The knocked-down containers are again examined for defects, counted and tied into specific sized bundles—all by hand. The bundles are then carried to a stacking corner (which is two sheets of plywood joined at a 90° angle). There they are hand loaded onto a pallet which has been placed in the corner. The pallet is then carried (again by hand

truck) to a semi-automatic load strapper where an operator guides the pallet to the proper position, lets the strapper apply the metal bands to one side of the load, hand turns the pallet 90°, and repeats the process. The boxes are now ready for shipping. (In some situations these last two steps may be omitted. The bundles may be individually hand loaded into trucks for immediate shipping.) This process generally takes approximately 16 employees who can produce roughly 6,800 boxes per hour.

The first station of the conversion process is the corrugator. A U.S. corrugator will usually be operated by 5 employees; the Colombia corrugator will usually be operated by 7 people (due to the lack of labor saving devices).

In Cali's production process, there are more points at which the quality of the products is examined. This is necessary since the use of inferior raw materials and older and less sophisticated equipment will produce more rejects. Due to the relative costs of labor and capital, it is more efficient to use manual rather than electronic (as is used in the U.S.) inspection systems.

Continuing Conversion Costs (Schedule I, lines 10-14)

Continuing conversion costs are those which will be incurred regardless of temporary increases or decreases in the level of production. They include such costs as salaries, administration and sales overhead, depreciation, insurance, property taxes and fixed corporate charges. Non-allocated labor, while composed predominantly of salaries and the payroll taxes and benefits attendant thereto, also includes the hourly wages of the few employees whose services can-

not be attributed to the production function. As is the case with production employees, however, Cali needs more administrative employees to perform the required work. While this is partially due to the greater burden of governmental paperwork, the primary cause is the lack of employees with prior education or training. Each job is therefore broken down into a number of small repetitive tasks which require little discretion.

Fixed plant charges (Schedule I, line 11) consist of depreciation, property taxes and insurance. Depreciation, which is the largest single component of this figure, accounts for 44 cents per MSF for the California plants and 37 cents per MSF for the Cali plant (both computed on a straight line basis). Although these figures will fluctuate depending upon the level of capacity at which each plant is operating (as will all continuing costs), the difference is small. The depreciation per MSF for the Cali plant would generally be expected to be considerably less than for the California facilities. This is partially a result of the use of less sophisticated, and therefore less expensive equipment by the Colombian operation. As can be seen from Schedule III, the 1974 cost of the Cali equipment, even after adding the additional freight, crating and insurance charges attributable to shipment from the U.S. and Europe, and import duties of 20% and adjusting for the differences in capacity, is two-thirds of the cost of the U.S. equipment. This rate would generally apply to the items in Schedule III since they perform functions which cannot reasonably be performed by hand. In order to maximize employment, the Colombian government assesses progressively higher duties on equipment which will reduce manual labor or for

which a substitute is locally available. Since these duties may exceed 300%, and the corporation would probably be required to retain any employee displaced by labor-saving equipment, there are effective additional "incentives" to use labor rather than capital intensive production techniques.

There are additional reasons for the lower depreciation charges. As has been noted in the Stipulation of Facts, there are numerous risks involved in doing business in foreign countries which do not exist in the United States. For most purposes of this section, these are the risks of nationalization and sabotage. Latin America is the region in which the most U.S. owned companies have been expropriated between 1960 and 1976 (Harvard Business Review, July-August 1977, Managing Against Expropriation pp. 75, 78). In order for a company to reduce its losses in the case of an expropriation, it will probably keep its investment to a minimum. If it wishes to begin operations in a country by building its own plant, it will use the minimum amount of equipment required to perform functions which cannot be done manually. It will probably purchase used, non-automated equipment, and will continue to use it for as long as practicable. It will recover as many of the costs attributable to the foreign operation as possible and will try to remit all earnings which are not reasonably necessary for the efficient operation of the business. It will try to hold reinvestment to that portion of earnings which cannot be remitted, and will lend money or guarantee loans to the subsidiary only where necessary.

As stated, used equipment will be purchased wherever feasible. (The corrugator, which combines medium with linerboard, was not included in Schedule III. Since it is the most expensive piece of equipment to be employed in a corrugated plant, it will almost always be purchased used, wherever there is a significant risk of nationalization. Due to the high cost, the comparison of either new corrugator prices or the comparison of new and used, between California and Cali, would have been distortive.) The used equipment will also be used long after it would have been scrapped in the United States. Therefore, in addition to the fact that the Cali plant would use less sophisticated and less costly equipment than the California operations, many of the depreciation charges would be based on the lower cost of used equipment and will not include any charge for equipment which, although still in use, has been fully depreciated. (Since Cali would use more used equipment and retain it longer, the use of new machinery costs from a single base period in Schedule III understates the actual differences between Cali and California's equipment costs.) Although machinery and equipment costs are generally the primary component of the property factor, the others are also material. As is the case with equipment, however, most of them are on incomparable bases from country to country (i.e., most property used in the property factor has a lower cost basis in less developed countries). For example, land in less developed, less populous areas will often be less expensive and buildings in tropical climates will often be built with lighter materials, less insulation, no air conditioning and will be constructed by inexpensive local labor.

Inventory, however, will be composed of more expensive raw materials and larger supplies will generally be retained (due to slow and uncertain deliveries).

Fixed corporate charges (Schedule 1, line 12) are the total corporate overhead expenses which have been allocated to the plant. In the case of the California plants, these include the costs of the U.S. corporate staff (i.e., industrial relations, personnel, law, tax, accounting, etc.), the operations staff (engineering and production methods, research and development, purchasing, architecture, etc.) and the shipping container division staff (marketing, research and development, etc.). Each of these expenses is allocated to the proper division (in this case the shipping container division) on the basis of the percentage of time spent for the benefit of the division (where such an allocation is practicable) or the division's conversion costs. These expenses are then allocated to the individual plants on the basis of conversion costs. The fixed corporate charges figure for the Cali plant is composed of both the allocated U.S. staff department costs (allocated to the international division and the specific plant on the same basis as they are allocated to the U.S. plants) and the Colombia staff department costs (allocated to the division and the plant on the basis of conversion costs). Since Cali is absorbing overhead from two corporations, their fixed corporate charges exceed those of the California plants. The average California plant charge of $0.81 is less than one-half of the Cali charge of $1.67. Although the amount of CCA overhead charged directly to the Cali plant in 1974 is unavailable, Carton de Colombia was charged a total of $544,767.

In order to reduce the risk that operations in 1974 are not comparable to the years 1963-1965, this analysis has focused on factors which are known to have remained relatively constant over the period such as competitive conditions, the availability of raw materials, the capital intensive operational structure in the U.S. versus the labor intensive structure in Colombia, the use of new, high speed equipment in the U.S. versus the use of used, slower equipment in Colombia and the allocation of corporate overhead between plants. It is also necessary, however, to rely on many factors which would change with the economic development and conditions of the two countries but which, due to the unavailability of historical records, could not be specifically traced. These include such factors as sales prices, material, labor, and equipment costs, profitability and productivity. The applicability of these factors, however, may be examined with regard to the context in which they were used; namely, to show relationships between the prevailing financial and economic conditions in the two markets. For example, between 1960 and 1970 the average annual growth rate of the Colombian GNP was 5.1% while the U.S. GNP grew at a 4.6% rate.[1] The differences in growth were even less when the growth rate of only manufacturing industries are considered (5.7% in Colombia versus 5.4% in the U.S.).[2] There were, however, greater differences in the rates of inflation between the two economies. After adjusting for the decline of the peso against the dollar[3] between 1963 and 74, the wholesale prices of Colombian raw materials (many of the materials purchased by Carton to manufacture its products) rose at a 5.5% rate while U.S. raw materials rose at a 6.8% rate[4],

and average hourly wages increased at a 2.3% rate in Colombia versus a 4.8% rate in the U.S.[3]. (This difference, which does not include what was probably a more rapid increase in Colombian employee benefits, was distorted by a 9 percent decline in earnings of the Colombian subsidiaries between 1963 and 65. Between 1965 and 1974, of the Colombian subsidiaries wages increased by 7% annually while U.S. wages increased by 6%.) The Colombian finished product wholesale price index (which reflects the price increases of some of Carton's purchases and the containers which they sell to customers) increased at a 3.0% rate during the eleven year period while the U.S. index increased by 4.4%.[4]

FOOTNOTES

[1]1975 United Nations Statistical Yearbook, Table 189 (Average Annual Rate of Growth of GOP at Constant Prices 1960-70).

[2]1975 United Nations Statistical Yearbook, Table 190 (Average Annual Rate of Growth of Manufacturing Industries at Constant Prices 1960-70).

[3]1970 and 1975 United Nations Statistical Yearbooks, Tables 185 and 194 respectively (Exchange Rates—Mid-point rates).

[4]1965 and 1975 United Nations Statistical Yearbooks, Tables 177 and 182 respectively (Wholesale Prices—based on index where 1970=100).

[5]1975 United Nations Statistical Yearbook, Tables 181 and 194.

[6]Schedule I information is from the 1974 Plant Reports for each enumerated location. The Colombia (Cali) reports were translated at a rate of 26.64 Pesos to the U.S. Dollar, the average of the beginning, midpoint and year-end exchange rates. Although the California information will not always correspond to that required for tax purposes (for example, benefits include all additional forms of employee compensation, regardless of whether they are reported on Federal Form 940, and depreciation is all computed on a straight-line basis), the figures for each plant are believed to be comparable.

[7]Weighted averages were computed on the basis of the average MSF produced and MSF shipped by each California plant. On this basis, Corona was assigned 23.4%, Oakland 20.5%, Fresno 19.3% and Malt Avenue 36.8%. Unit production and shipment figures, however, were computed on the basis of a straight average.

[8]For domestic plants, total employee benefits were allocated between variable and continuing costs on the basis of the percentage attributable to hourly labor (primarily variable) and salaried labor (primarily continuing). Colombian benefits were separately attributed to each category in the plant reports.

[9]Cali's plant report did not state depreciation or CCA overhead separately. These figures, as used in the Continuing Conversion Cost section of the text were specially obtained from Carton de Colombia.

[10]Wages, Benefits and Payroll Taxes Charged to Production was computed by multiplying the Schedule I, Line 7 figures by the MSF produced by each plant.

[11]A 1976 CCA study shows that for each dollar of hourly labor cost incurred by a CCA affiliated corrugated plant, payroll taxes and benefits account for 27.0% of total U.S. cost and 45.9% of the total Colombian cost.

[12]Obtained from separate CCA and Carton de Colombia reports.

[13]Schedule III traces the typical process of conversion of corrugated board into a finished, knocked down container which is ready for shipping by the Cali and an average California plant. Since specific information is not available for the years at issue, 1974 is used as an example. The 1974 Equipment Cost figure is the cost of each piece if it has been newly purchased. All figures on this page are approximations. While they are not presented for their accuracy, it is believed that this example does express the general scope of differences between the production functions of the Cali plant and the California plants for the years at issue.

[14]Income and Apportionment information is from Exhibits A-1 through A-7 of the Stipulation of Facts.

[15]Exhibits A-1 through A-7 of the Stipulation of Facts in this lawsuit.

[16]Exhibit B-2 of the Stipulation of Facts in this lawsuit.

[17]Exhibit B-1 of the Stipulation of Facts in this lawsuit.

SCHEDULE I

Sales Price and Cost of Corrugated Container Production on a Per Unit (Thousand Square Feet—MSF) Basis[6]

	Corona	Oakland	Fresno	Malt Ave. Los Angeles	Weighted Average[7]	Percent of Sales Price	Cali	Percent of Sales Price
1. Total MSF Produced	427,965	374,322	351,941	671,097	456,331		211,778	
2. Total MSF Shipped	429,306	376,227	352,755	675,935	458,556		212,704	
3. Sales Price*	25.16	25.73	24.67	24.49	24.93	100	32.17	100
Material Costs								
4. Paperboard	12.94	12.90	12.49	12.60	12.72	51.0	20.56	63.9
5. Other	1.19	1.26	.81	1.28	1.17	4.7	1.14	3.6
6.	14.13	14.16	13.30	13.88	13.89	55.7	21.70	67.5
Variable Conversion Costs								
7. Manufacturing Labor[8]	2.64	3.09	2.20	2.64	2.63	10.6	1.19	3.7
8. Other	1.70	1.26	1.12	1.24	1.35	5.4	1.00	3.1
9.	4.34	4.35	3.32	3.88	3.98	16.0	2.19	6.8
Continuing Conversion Costs*								
10. Non-Allocated Labor[8]	1.76	1.96	1.73	1.93	1.85	7.4	1.18	3.7
11. Fixed Plant Charges[9]	1.33	1.08	.88	.96	1.05	4.2	.49	1.5
12. Fixed Corporate Charges[9]	.79	.82	.67	.88	.81	3.2	1.67	5.2
13. Other	.50	.38	.42	.36	.41	1.7	.39	1.2
14.	4.38	4.24	3.70	4.13	4.12	16.5	3.73	11.6
15. Inventory Charges & Other Misc. Costs*	—	(.02)	(.09)	—	(.03)	(0.1)	(.06)	(0.2)
16. Profit Before Income Tax*	2.31	3.00	4.44	2.60	2.97	11.9	4.61	14.3
17. Return on Invested Capital (after Tax)	14.2	23.9	35.2	22.6	23.3		42.9	

*Denotes distribution on basis of MSF shipped. All other costs are computed on basis of MSF produced.

**Invested capital is capital stock, paid in surplus, earned surplus and long-term debt which are allocated to individual plants on the basis of conversion costs.

SCHEDULE II

Analysis of Hourly Labor Costs for Corrugated Plants

	Corona	Oakland	Fresno	Malt Ave.	Weighted Average[7]	Cali
1. MSF Produced	427,965	374,322	351,941	671,097	456,331	211,778
2. Manhours Worked (Hourly) Wages, Benefits and Payroll Taxes	174,010	147,767	115,392	224,381	175,853	207,542
3. Charged to Production[8, 10]	1,127,991	1,157,395	774,303	1,772,102	1,302,790	250,338
4. Total Hourly Labor, Benefits, Payroll Taxes[6]	1,268,430	1,494,618	883,490	1,891,772	1,469,895	250,338
5. Average Number of Hourly Employees	94.1	83.0	62.5	111.7	92.2	80.1
6. Manhours per MSF	.41	.39	.33	.33	.39	.98
7. Labor Cost per Manhour	6.48	7.83	6.71	7.90	7.41	1.21
8. Labor Cost per MSF	2.64	3.09	2.20	2.64	2.85	1.19
9. Total Annual Cost per Hourly Employee[9]	13,480	18,007	14,136	16,936	15,942	3,125
10. Direct Wages[11]					11,638	1,691
11. Payroll Taxes and Benefits[11]					4,304	1,434
12. Average Machinery and Equipment In Use (1974)[12]	2,680,984	2,080,259	2,293,045	3,219,155	2,681,010	899,838
13. Machinery and Equipment per MSF Produced	6.26	5.56	6.52	4.80	5.88	4.25
14. Total Property (Schedule IV, Line 4) per Total Sales (Sch. IV, Line 6)	.54	.41	.45	.36	.42	.28

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SCHEDULE III

Structure of Corrugated Plant Production Processes[13]

	Employees per Station	Approx. 1974 Equipment Cost	Approx. Average Output per Hour of Running Time
California Plants			
Flexo-Folder-Gluer	2	200,000	8,000
Automatic Bundler	1	9,000	
Automatic Palletizer	1	20,000	
Load Strapper	1	40,000	
Conveyer System (portion attributable to this portion of converting operation)		100,000	
	5	369,000	
Labor Cost/Manhour (Sch. II, Line 7, Col. 5)	7.41		
Total Hourly Labor Cost	37.05		
Cali Plant			
Letterpress Printer-Slotter	3	100,000	6,800
Bostitch Folder-Gluer (no counter/ejector)	4	50,000	6,800
Manual Bundling	3		
Stacking Corner (palletizing)	2		
Semi Automatic Load Strapper	1	12,000	
Hand Carts (3)	3	1,500	
	16	163,500	
Labor Cost/Manhour (sch. II, Line 7, Col. 6)	1.21		
	19.36		
Additional Freight, Crating and Insurance for International Shipment		13,100	
Colombian Duties (approx. 20% on this equip.)		32,700	
Additional Labor & Equipment Needed to Equalize Capacity (17.57)	3.40	36,600	
	22.76	245,900	

SCHEDULE IV

1974 Apportionment Computations for California and Cali Corrugated Plants

	Corona	Oakland	Fresno	Malt Ave.	Weighted Average[7]	% Return on Factors	Cali	% Return On Factors	Factor Totals Calif., Cali
1. Net Income Before Tax	991,834	1,128,941	1,565,711	1,755,703	1,411,803		976,689		2,388,492
Property[12]									
2. Average Owned	5,321,995	3,068,286	3,641,657	5,404,001			1,899,408		
3. Rental Expense (x8)	473,832	857,528	280,144	529,544			32,136		
4.	5,795,827	3,925,814	3,921,801	5,933,545	5,101,468	27.7	1,931,544	50.6	7,033,012
5. Payroll	1,887,194	1,894,946	1,382,233	3,070,186	2,226,667	63.4	498,161	196.1	2,724,828
6. Sales	10,799,752	9,680,795	8,703,444	16,552,448	12,282,770	11.5	6,842,155	14.3	19,124,925

	California	Cali
Apportionment Ratios for Calif., & Cali, Plants		
7. Property	72.5360	27.4640
8. Payroll	81.7177	18.2823
9. Sales	64.2239	35.7761
10. Average	72.8259	27.1741
Net Income		
11. As Apportioned	1,739,441	649,051
12. As Allocated	1,411,803	976,689
13. MSF Shipped	458,556	212,704
14. Allocated Profit Per MSF	3.08	4.59
15. Apportioned Profit Per MSF	3.79	3.05
16. Allocated Return on Sales	11.5	14.3
17. Apportioned Return on Sales	14.2	9.5
18. Allocated Return on Assets	27.7	50.6
19. Apportioned Return on Assets	34.1	33.6

SCHEDULE V

1963-65 Apportionment Computations for CCA and Colombian Affiliates[14]

		Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1963	CCA	93.10	87.62	98.66	93.13	25,362	28,272
	Colombia	6.90	12.38	1.34	6.87	4,996	2,086
						30,358	30,358
1964	CCA	92.77	87.22	98.54	92.84	28,975	31,322
	Colombia	7.23	12.78	1.46	7.16	4,763	2,416
						33,738	33,738
1965	CCA	94.40	88.55	99.14	94.03	30,027	31,056
	Colombia	5.60	11.45	.86	5.97	3.001	1,972
						33,028	33,028

	Average Income Per Separate Accounting 1963-5	Average Income Per Apportionment 1963-5	Average Sales[15]	Separate Income Sales	Apportioned Income Sales
				Return on Sales	
CCA	28,121	30,217	298,210	9.43	10.13
Colombia	4,254	2,158	20,955	20.30	10.30
	32,375	32,375	319,165	10.14	10.14

	Average Invested Capital[16]	Return on Invested Capital	
CCA	214,570	13.11	14.08
Colombia	20,739	20.51	10.41
	235,309	13.76	13.76

	Average Net Assets[17]	Return on Net Assets	
CCA	251,738	11.17	12.00
Colombia	25,837	16.46	8.35
	277,575	11.66	11.66

SCHEDULE VI

1963-65 Apportionment Computations for Countries In Which CCA or Affiliates Operated[14]

	1963					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	76.67%	66.57%	87.15%	76.80%	$25,362	$27,769
2. Colombia	5.69	9.41	1.18	5.42	4,996	1,960
3. Mexico	3.56	4.48	1.80	3.28	825	1,186
4. Venezuela	3.78	6.81	2.53	4.37	2,179	1,580
5. Panama	—	—	—	—	1,412	—
6. Austria	—	.11	—	.04	(37)	15
7. Germany	6.86	8.35	5.72	6.98	1,194	2,524
8. Holland	.75	.31	.32	.46	323	166
9. Italy	2.69	3.96	1.30	2.65	(96)	958
10. Total Overseas	23.33	33.43	12.85	23.20	10,796	8,389
11. Total Combined					$36,158	$36,158

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	1964					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	75.22%	67.80%	86.52%	76.51%	$28,975	$32,941
2. Colombia	5.88	9.93	1.29	5.70	4,763	2,454
3. Mexico	3.69	4.30	1.90	3.29	1,709	1,416
4. Venezuela	4.91	6.15	2.86	4.64	5,161	1,998
5. Panama	—	—	—	—	773	—
6. Austria	—	.08	—	.03	(58)	13
7. Germany	7.16	7.90	5.71	6.93	1,394	2,984
8. Holland	.81	.31	.35	.49	397	211
9. Italy	2.33	3.53	1.37	2.41	(59)	1,038
10. Total Overseas	24.78	32.20	13.48	23.49	14,080	10,114
11. Total Combined					$43,055	$43,055

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	1965					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	75.29%	70.51%	86.10%	77.30%	$30,027	$35,493
2. Colombia	4.48	9.11	.75	4.78	3,001	2,195
3. Mexico	4.27	4.45	2.28	3.67	2,281	1,685
4. Venezuela	5.27	5.68	3.06	4.67	5,398	2,144
5. Panama	—	—	—	—	1,673	—
6. Austria	—	.04	—	.01	56	4
7. Germany	7.77	7.13	6.08	6.99	2,791	3,210
8. Holland	.76	.30	.35	.47	431	216
9. Italy	2.16	2.78	1.38	2.11	258	969
10. Total Overseas	24.71	29.49	13.90	22.70	15,889	10,423
11. Total Combined					$45,916	$45,916

(Table continued on following page)

(Continued from preceding page)

	Average Pre-Tax Income per Separate Acct. 1963/64/65	Average Pre-Tax Income per Apportionment 1963/64/65	Average Sales[15]	Return on Sales: Sep. Income Sales	Return on Sales: Apport. Income Sales
12. CCA	$28,121	$32,068	$298,210	9.43%	10.75%
13. Colombia	4,254	2,203	20,955	20.30	10.51
14. Mexico	1,605	1,430	15,214	10.55	9.40
15. Venezuela	4,246	1,907	18,503	22.95	10.31
16. Panama	1,286	—	—	N/A	N/A
17. Austria	(13)	11	—	N/A	N/A
18. Germany	1,793	2,906	28,711	6.24	10.12
19. Holland	384	197	3,048	12.60	6.46
20. Italy	34	988	9,371	0.36	10.54
21. Total Overseas	13,588	9,642	95,802	14.18	10.06
22. Total Combined	$41,710	$41,710	$394,012	10.59	10.59

(Table continued on following page)

(Continued from preceding page)

	Return** on Invested Capital			RETURN ON TOTAL ASSETS		
	Average Invested Capital[16]	Sep. Income Avg. Invest. Capital*	Apport. Inc. Avg. Invest. Capital*	Total Assets[17] (1963-1965)	Separate Income Assets (%)	Apportioned Income Assets (%)
12. CCA	$214,570	13.11%	14.95%	$351,238	8.01	9.13
13. Colombia	20,739	20.51	10.62	34,010	12.51	6.48
14. Mexico	10,798	14.87	13.22	16,294	9.85	8.78
15. Venezuela	13,453	31.56	14.18	20,503	20.71	9.30
16. Panama	13,200	9.74	0	14,178	9.07	—
17. Austria	230	(5.65)	4.78	251	(5.18)	4.38
18. Germany	13,065	13.72	22.24	25,331	7.08	11.47
19. Holland	1,824	21.05	10.80	2,969	13.87	7.11
20. Italy	5,689	0.60	17.37	12,096	.28	8.17
21. Total Overseas	78,998	17.20	12.21	125,430	10.83	7.69
22. Total Combined	$293,568	14.21	14.21	$476,668	8.75	8.75

*Average pretax income divided by average invested capital at the beginning of the years 1963-1966 (the latter figures are from Exhibit B-2 of the Stipulation of Facts.

**Average pretax income 1963-1965.

(Table continued on following page)

SCHEDULE VII

RETURN ON AVERAGE INVESTED CAPITAL*

	1963	1964	1965	% Variation Difference Between High and Low
U.S.	12.27%	13.38%	13.50%	10.02%
Colombia	26.37	21.85	13.32	97.97
Mexico	9.02	15.92	18.32	103.10
Venezuela	17.79	39.11	36.83	119.84
Germany	10.80	10.73	18.51	72.51
Holland	17.49	22.65	23.93	36.82
Italy	(1.58)	(1.01)	4.87	—

*Calculating by averaging the invested capital (from Exhibit B to the Stipulation of Facts) at the beginning and end of the year.

EXHIBIT 2 TO
STIPULATION RE
TESTIMONY

STATEMENT OF WILLIAM P. LEE RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

Of the primary operations of CCA and the foreign subsidiaries (the production of boxboard, linerboard and medium, and their conversion into folding cartons and corrugated containers), the corrugated conversion operations in different countries are the least dissimilar (i.e., the basic materials, processes and equipment are the most standardized). As a result, to the extent financial comparisons are valid between CCA and the foreign subsidiaries, the comparison of the corrugated operations is the most meaningful. I have examined the comparisons testified to by Thomas M. Kucharvy and attached to this Stipulation re Testimony as Exhibit 1, including the supporting Schedules thereto. Those comparisons have been made between the corrugated plant in Cali, Colombia and the four corrugated plants in California for the year 1974. The products being produced and the methods of operation were essentially similar for the years 1963-1965 to those in 1974. I believe, and other officers of CCA believe, that if these comparisons could be made for all corrugated plants for the years 1963-1965, the differences in productivity, hourly labor costs and unit labor costs would be at least as great, and probably greater, than those shown for 1974. However, for the European countries, the differences would not be as great as for the Latin American countries. No similar figures are available for any countries for the years in suit.

EXHIBIT 3 TO
STIPULATION
RE: TESTIMONY

STATEMENT OF HARRY E. GREEN RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

CCA's general philosophy, including the years before, during and after the years involved in this suit, was to have a substantially greater return from businesses overseas than from businesses domestically. CCA used "hurdle" rates in evaluating investment decisions both domestically and abroad. "Hurdle" rates refers to the minimum returns which must be anticipated by CCA before a new investment will be made or an existing investment will be expanded. The hurdle rates used by CCA during 1963-1965 were 10% return on investment from domestic operations and 15% return on investment from foreign operations, except that an 11-12% return on investment would more likely have been used for the safer European countries, Germany and Holland. However, it must be understood that while "hurdle" rates are the minimum returns which must be anticipated before an investment will be made, those "hurdle" rates of return generally fall below the reasonably anticipated rates of returns. CCA expected the domestic operations to yield an average after tax return on investment of between 10% and 12%; CCA expected the overseas operations to yield an average after tax return on investment of between 18% and 20%. Indeed, it was the inability of the German operations to meet these

profit requirements which led to their sale in 1967. CCA felt this money could be more profitably employed in less developed countries of Latin America. In general, these greater profits have also been achieved in the years after the years in suit.

In the Superior Court
of the
State of California
In and for the
City and County of San Francisco

[Title Omitted in Printing]

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Thursday, February 23, 1978

Testimony of: John C. Mc Donald

APPEARANCES:

For the Plaintiff:

MORRISON & FOERSTER
1 Market Plaza
Spear Street Tower
San Francisco, California 94105
By: FRANKLIN C. LATCHAM, Esquire,
and PRENTISS WILLSON, JR., Esquire

For the Defendant:

HON. EVELLE J. YOUNGER,
Attorney General
By: PHILIP M. PLANT, Esquire
Deputy Attorney General

INDEX

Witnesses:

For the Plaintiff:	DIRECT
MC DONALD, John C.	4, 9

Exhibits:

PLAINTIFF & DEFENDANT (Joint)	EVIDENCE
1 —Stipulation of Facts	2
1-A—Addendum to Stipulation of Facts	2
For the Plaintiff:	
2 —Stipulation re Testimony	3

THURSDAY, FEBRUARY 23, 1978

11:25 O'CLOCK A.M.

The Court: Container Corporation of America, Plaintiff, versus Franchise Tax Board, Number 673 492.

Counsel, are you ready?

And for the reporter's benefit, may we please have your appearances?

Mr. Latcham: Frank C. Latcham for the Plaintiff Container Corporation.

Mr. Willson: Prentiss Willson, Jr., also for the Plaintiff Container Corporation.

Mr. Plant: Philip M. Plant appearing on behalf of the Defendant Franchise Tax Board.

The Court: Thank you. Mr. Latcham and Mr. Willson?

Mr. Willson: We would like to introduce Plaintiff and Defendant's Joint Exhibit No. 1. I will pass the series of exhibits to the clerk.

The Court: I understand that Plaintiff and Defendant's Joint Exhibit 1 is a Stipulation of Fact with attached exhibits?

Mr. Willson: Yes. There also is in the file an addendum to the Stipulation of Fact, an additional paragraph.

The Court: There is no objection to the addendum, Mr. Plant?

Mr. Plant: No, your Honor, no objection.

Mr. Willson: With regard to that, your Honor, I have, if it will be helpful to you, an extra copy, which includes the stipulation which you just introduced, and all the exhibits, save one bulky exhibit, which it is unlikely anyone will ever look at. Would this be helpful to you to have this?

The Court: Has counsel had an opportunity to see that?

Mr. Plant: Yes. No objection.

The Court: It looks like it would be easier if the clerk keeps the original and I can have the copy to work on.

Mr. Willson: Yes, your Honor.

The Court: All right, thank you. That would be, just for the record, to keep track, that will be 1-A in evidence. And if I refer to 1-A, it is that item which will be for identification.

Plaintiff and Defendant's Joint Exhibit 1 is introduced in evidence.

1-A is for identification, and that is for the Court's copy which was presented by counsel.

1-A can be withdrawn at the end. In the event of any appeal, 1-A does not have to go with 1.

(Plaintiff and Defendant's Joint Exhibits 1 and 1-A previously received and marked for identification, were admitted into Evidence bearing the same designations.)

Mr. Willson: Your Honor, we also have a Stipulation re Testimony of several people, which will be plaintiff's exhibit. It is not a joint exhibit.

The Court: It will be Plaintiff's Exhibit 2, which is a Stipulation re Testimony. And that consists of approximately twenty-five pages?

Mr. Willson: Yes.

The Court: And as I understand it, the Franchise Tax Board, Mr. Plant, has an objection to certain portions of that stipulation based on objections of relevancy, and so on, that have been agreed may be raised by objection in submitting the stipulated statement?

Mr. Plant: That is correct, your Honor. These reservations of rights to object are incorporated in the first two pages of the Stipulation re Testimony.

(Plaintiff's Exhibit 2 previously received and marked for identification, was admitted into Evidence bearing the same designation.)

The Court: All right. Now based on our discussion, there will be a brief schedule for the submission of briefs on the issue of the objections to questions of the Stipulation re Testimony. And that would be ten days to the Defendant Franchise Tax Board to set forth their brief on the objections;

Ten days to the Plaintiff Container Corporation of America to respond;

And five days for any final rebuttal.

Then that issue is submitted subject to briefing?

Mr. Willson: Yes.

Mr. Plant: Yes.

The Court: The next item I believe is a witness to call on behalf of plaintiff.

And we indicated we could proceed with his testimony, at least as to his qualifications, so that he may be qualified as an expert before the lunch break.

Mr. Willson: Yes.

JOHN C. Mc DONALD

called as a witness by and on behalf of plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: Your name, sir?

The Witness: John C. Mc Donald, M-c-D-o-n-a-l-d.

The Clerk: And the address, sir?

The Witness: 1098 Vernier Place, Stanford, California.

The Clerk: Thank you. Would you take the stand?

DIRECT EXAMINATION

By Mr. Willson: Q. Professor Mc Donald, will you state your profession and current position?

A. I am Professor of Finance in the Graduate School of Business, Stanford University.

Q. What has been your background in the field of finance, and training?

A. I received a Bachelor's Degree in Engineering with honors in 1960 from Stanford.

I went on to get a Master's Degree in Business Administration, MBA, with emphasis in finance, in 1961.

Then after about four years of military and working experience, I did a Ph.D. in Business Administration, with emphasis again in finance, also at Stanford. I completed that in 1967.

I have been teaching on the Stanford faculty for the last ten years.

Q. Has your training included any training in economics?

A. Yes, it does. Part of the Ph.D. Degree in the Stanford business school includes quite a number of courses also taken by the doctoral students in economics across the street from the business school, in the economics department itself.

Q. Will you tell us about your teaching experience?

A. In addition to teaching the Stanford business school, I have taught at Columbia business school in New York City, and have taught, as well, at four European business schools.

The University of Paris School, Insead, I-n-s-e-a-d;

The International Business School at Fontainebleau, France.

The French Business School called capital H capital E capital C;

And the London Business School.

In each of these cases the course material has to do with corporate financial management, which has to do with the management of businesses from a financial point of view,

and with investment knowledge, which has to do with the management of investment portfolios, and an understanding of the companies that lie behind those portfolios, common stocks and bonds.

I should add, the notion of yardsticks as a financial performance, the measures by which one judges financial performance of a company is a subject included in all of these courses.

Q. What has been your experience with businesses in the field of finance and investment?

A. I have acted as a consultant to a number of bank trusts departments, with the subject of the designing of the process by which they make investments, decisions, the key topic of interest.

In addition, I have worked with about ten banks on the subject of lending decisions. That is the process by which corporate lending officers lend money to companies in the United States and abroad. About five major New York banks, and about five banks out here on the Coast.

The banks, as you know, view these lending decisions as investment decisions in terms of investing the bank's money in the businesses to which they lend.

Then I now serve as a director in six public companies. These are all corporations which are investment companies, commonly called mutual funds, which are invested primarily in common stocks and bonds. That is the securities corporations.

I also serve as a member of an advisory committee to one of the major oil companies with regard to the invest-

ment of the pension monies of the employees of that oil company.

That is a pool of capital of about nine hundred million dollars. That is an advisory role rather than running the money itself.

There are five of us on that advisory committee.

That, I believe, is the major outline of my business interest and experience.

Q. How much of this experience is foreign, international in scope, as opposed to domestic?

A. I have served as a consultant to a number of businesses that are domiciled outside the United States. Several in Europe, and one in Africa.

I think the major international emphasis comes from the fact that so many American businesses, so many businesses that are headquartered here in the United States, have a substantial part of their business abroad.

It is very common these days to find American companies that have a half or more of their profits that are earned abroad.

So the international arena, the international emphasis has become very, very important for many, many American companies of all sizes.

Q. In these various contexts then, how many companies would you say you have examined?

A. I would say the total runs into the hundreds. I have been a direct consultant to, I would say, dozens of companies.

And in the context of examining companies for purposes of investment, either common stock investment, bond investment, or lending investments on the part of banks, I think I have examined in some detail hundreds of companies.

Q. Are there any relevant publications of yours in this area?

A. I am the author or co-author of more than thirty publications that have been published in journals.

In addition, I wrote a dissertation, partial fulfillment, for the doctoral degree which I had to do with financial management, as well.

Mr. Willson: I have no further questions on qualifications, your Honor.

The Court: Do you wish to voir dire?

Mr. Plant: No, your Honor, we will accept him as an expert in the area of foreign investments.

The Court: All right, the witness will be designated as an expert for those purposes.

Mr. Willson: It will take us about two hours, your Honor. I think it would be better continuity if we could have lunch and break and come back.

The Court: I indicated I had a meeting, so if I can recess until 1:45, I should be available at that time.

Mr. Willson: All right.

The Court: Is that agreeable to counsel?

Mr. Plant: Yes. Thank you.

(Whereupon, the luncheon recess was taken.)

AFTERNOON SESSION 1:45 O'CLOCK P.M.

The Court: Dr. McDonald, would you resume the stand?

Mr. Plant: As a preliminary matter, could I make a request, Dr. Cerf, from the UC graduate school in Berkeley is here in an advisory capacity. May he have leave to sit with me at counsel table?

The Court: Yes.

Mr. Willson, you may proceed.

JOHN C. McDONALD,

resumed the witness stand and testified further as follows:

Mr. Willson: Q. Let me begin, Dr. McDonald, could you define what we mean by rate of return, or return on investment?

A. Rate of return and return on investment are phrases that refer to basic measures of business profitability.

Q. How is that determination made?

A. There are two basic classifications of definitions of rate of return.

The first, and perhaps the broadest, is a ratio that involves some measure of profit or income, in the numerator, and some measure of investment base or invested capital in the denominator of the fraction.

There may be many variations on a theme that the income may be pretax or after tax income.

And, likewise, there are many different definitions of exactly the determination of the investment base used from case to case or company to company.

But the basic notion of a ratio is a very general one.

The second category or definition of rate of return is that discounted cash flow, or sometimes called the DCF rate of return. And this, essentially, is a summary figure which is prospectively looking towards summarizing the rate of return on a further sequence of cash flows or profits from a given investment.

Q. Could you give us a simple example of rate of return?

A. In terms of the first ratio that I spoke of, for example, if a company, in other words, were to invest a hundred dollars in a given project, and were to receive in the first year after tax income of fifteen dollars, then the rate of return would be 15 divided by 100, or 15 percent.

Q. What is the usefulness of the concept of rate of return to businesses?

A. The basic usefulness, I think, is to, first of all, give them a tool for measuring profitability so as to enable them to control their business.

That is the notion of financial controls says that you have to have some sort of a measure of basic profitability of the units or segments or divisions of that business. So that businesses are interested in the amount of money invested

in each segment or divisions or partitions of the business, and they are interested in how much profit each of those divisions generates, and the ratio of those is the rate of return on each of those units.

So this is basically the first class of uses which has to do with financial control.

I think the second class of uses has to do with making investment decisions when there are a lot of alternatives available in a business.

This is called capital budgeting, or investment decision-making, resource allocation.

What this says is essentially you would like to, so much as it is possible, make new investments in more profitable rather than less profitable areas, if all other things are equal.

The two basic categories are financial control and capital budget or investment decision-making, in my experience.

Q. Is it fair to say companies have more uses for funds than they will have funds available?

A. I have found that it varies a lot from company to company, of course.

But in the case of very many companies, they have many more ideas, many more opportunities than they have dollars available.

Some companies have what they call a wish list, where people in the various divisions of the company come up with ideas, often not very precisely formulated at that

stage, of things which might take additional investment capital, machines, new product ideas, and so on.

And this wish list can be as much as four or five or even ten times as great as the amount of money that is available.

So, generally speaking, companies have more ideas than they have money.

Q. How then does a business decide which of these competing alternatives that they will approve?

A. I think the most general criterion has to do with the expected profitability of each of those potential uses of capital on that wish list

The usual yardsticks that are used, the usual words that are used to describe these criteria vary a lot from company to company.

But in my judgment, the underlying thread running through it has to do with the expected profitability of the alternatives at hand.

The Court: You said "expected"?

The Witness: Expected, yes.

Mr. Willson: Q. Are you familiar with the term "Hurdle Rate"?

A. Yes.

Q. What do people commonly mean by that?

A. Businesses generally take the phrase "Hurdle Rate" to mean the minimum expected rate of return that is required for them to accept a new project that has been proposed by someone with the company.

So "Hurdle Rate" essentially is a minimum required rate of return of new investments.

Q. Do companies have the same "Hurdle Rates" for each of these competing investment alternatives that you described earlier?

A. Some companies do have a single "Hurdle Rate" for all investments, but a great many companies have different "Hurdle Rates" for different kinds of investment proposals.

The basic notion being many companies have different kinds of products or operations in different countries, where the investment proposals are like apples and oranges, really.

And in these cases, companies often have different "Hurdle Rates" for different kinds of investments.

Q. Could you give us an example, perhaps from your experience, of what these different "Hurdle Rates" might be? What is the magnitude of the rates?

A. I was recently talking with financial officers of a company that had "Hurdle Rates" in the range between 18 percent after tax return and 30 percent after tax return for different classes of investment proposals.

And this particular company, they divided things up into four categories:

Foreign versus domestic, and new products versus line extensions of existing products.

And the four categories went something like this:

For an investment proposal which was domestic, that is involved expenditure of capital funds in this country, and which was to be used for a line extension, that is an extension of an existing business, where they had some experience, and were already involved in, the "Hurdle Rate" was 18 percent.

And at the top of the spectrum, Category 4, were investments which were made abroad with foreign, and which were new products, that is lines of businesses in which they were not already invested.

And in between, in Category 2, you had a domestic investment in new products.

And Category 3 were line extensions abroad.

So essentially as it stepped up from 18, 22, 26, 30 percent, it went through the categories of domestic line extension, and then domestic new products, and then foreign line extension and finally foreign new products.

This is just an example of four different "Hurdle Rates" used by a single company.

Q. Would you say this approach is typical, companies perhaps might divide it up differently, but the approach of having different "Hurdle Rates"?

A. In my experience, many medium and large size companies do now have multiple "Hurdle Rates."

And the general approach, this general approach, is used in most of these companies.

The exact way they describe the categories and the exact means of assigning one sort of investment to one sort of

category or another obviously varies from company to company.

But the notion of a range is rather general, in my experience.

Q. The specific "Hurdle Rates," could we find those in publications?

A. Generally one could not find those in publications. These "Hurdle Rates" are regarded by the companies that I know as proprietary information, the sort of thing they don't like to reveal to competitors, and they don't like generally to reveal this in their financial statements, although there are instances of some companies that have actually put a "Hurdle Rate" or more in their annual report.

This is relatively rare, in my judgment.

So that one doesn't go to the library to find those kind of numbers, but rather one comes to this through actual contacts with companies.

Q. Have you specifically looked to see recently if there is published information on this point?

A. My perusal of journals as they come along, and with my working not far from the Stanford business school library, has led me to conclude that there is relatively little in the published record about the actual multiple "Hurdle Rates" that companies use.

There have been a few articles that are indicative of the subject by mentioning "Hurdle Rate" in the title.

But once you read these articles, they are relatively general, or they come from relatively small samples of companies, to which companies have replied with rather sketchy data.

Q. In your experience, how do the "Hurdle Rates" compare as between the United States and the rest of the world?

A. Generally "Hurdle Rates" are higher for investments to be made abroad than for investments to be made by American companies here in the United States.

The simplest way of dividing it up is to think simply of domestic versus foreign.

And in that case, the foreign "Hurdle Rates," in my experience, are generally higher than the "Hurdle Rates" that are applied for similar line of businesses here in the United States.

The next step that some companies have used is to divide the world up into domestic, and then foreign industrialized countries, which have a somewhat higher "Hurdle Rate" generally than the domestic American situation.

And thirdly, foreign less developed countries, or developing companies, which is a still higher "Hurdle Rate."

Even this three part classification is obviously crude, because there are lots of differences among countries in industrialized categories and the development category, as well.

Q. Switzerland is often regarded as a haven for capital, a safe place to put your capital.

Would you say that Switzerland is less risky, in that there would be a lower "Hurdle Rate" in Switzerland than in the United States?

A. No. My experience is that "Hurdle Rates" are generally higher, even in Switzerland, than in the United States.

But the general impression has some validity. That is during the World War, and the impression of people in many countries in Europe and in the Middle East, and the Far East, as well, Switzerland is a relatively safe country, and I think that impression is valid.

But compared to the United States, which is a much larger country, a much more diversified country, because of all the attributes that we understand in general terms and my impression has been that both American and Swiss-based countries regard the United States as being less risky than Switzerland, and that the margin is to require a lower "Hurdle Rate" here than they do in Switzerland.

Q. Have you reviewed the Stipulation of Facts in this case, Plaintiff and Defendant's Exhibit 1?

A. Yes, I have.

Q. You will recall that Container has operated subsidiaries in three Latin American companies, Venezuela, Colombia and Mexico.

Where would you currently place those countries in this "Hurdle Rate" comparison?

A. In terms of the structure that I outlined a few moments ago, I would put those three countries in the foreign developing category.

Q. And where would you place the operating subsidiaries in Europe, specifically Italy, Germany and Holland?

A. I would put all three of those countries in the foreign industrialized country category.

But I should add that Germany would be rather near the top of the industrialized country category, in the sense that it would be closest to the United States.

And Italy would be near the bottom, I think, in the sense that it would be furthest from the United States.

Q. How would you compare the changes in the difference between the relationship—the differences in the relationships in the "Hurdle Rate" through the years 1963 through '65 as compared to the present time?

A. Well let's take the United States first, and look at American companies as they have set "Hurdle Rates" for domestic investments.

Generally over the past ten or fifteen years, companies have raised their "Hurdle Rates." And, at the same time, many of them have raised their "Hurdle Rates," as well, for foreign industry.

So that one general statement that one can make is that, in my experience, companies generally have higher "Hurdle Rates" today than they did fifteen years ago.

But as regards that required return in foreign countries, it depends a lot on the foreign country.

But one example which might illustrate this would be a company with which I am familiar, that in 1965 had a spectrum of "Hurdle Rates" running from 15 percent to 25 percent. And today they have a spectrum of "Hurdle Rates" going from 20 to 30 percent.

Q. Are there any countries where the gap had widened in the intervening years between '63 and '65 as compared to now?

A. I understand your question to mean a gap between "Hurdle Rates" required domestically and that in foreign countries?

Q. Yes.

A. And I think if you look at examples like Peru and Chile, those countries are generally viewed as being riskier today than they were ten or fifteen years ago.

Q. Any European countries that might be riskier today than they were fifteen years ago?

A. Yes, I would think many countries view Italy as being riskier today than it was fifteen years ago, because of the political changes there.

And some even regard Great Britain as being riskier today than fifteen years ago.

Q. Would there be any countries where the gap has lessened?

A. Yes, I think there are.

I think if you compare domestic investments invested in Germany, which has grown and diversified and become

much stronger in the last fifteen years, you find that gap between the domestic investments and investments in Germany would reflect a somewhat narrowing spectrum of "Hurdle Rates."

I think the same might be true of Japan because of the development there.

And the perception that the basic underlying risk of the economic and political system in those countries is less today than it was fifteen years ago.

Q. What would be your expectation for the future?

A. My expectation is there will continue to be a spectrum.

As I look out over the next decade or generation, the United States, because of its size and because of its relative political stability, and because of its institutions, all of those things that we know to be the economic and social and political stability and power of the United States, will continue to make it the lowest risk place in the world in which to invest.

The Court: Gentlemen, I have received another group of questions from the jury we have out.

You were just about, I think, through with this particular thought on the spectrum?

Mr. Willson: Yes.

The Court: Did you have another question?

Mr. Willson: Yes. One question, and that would be a nice stopping point.

The Court: All right.

Mr. Willson: Q. These five points, then, would you expect that these differences between foreign countries and the United States will be worked out in our lifetime?

A. No, I would not think they would be in our lifetime. There will be many changes country to country abroad.

But my general expectation is that all foreign countries will continue to have "Hurdle Rates" in the years ahead, at least in our lifetime, which will be somewhat higher in the United States than they are today.

Mr. Willson: This is a good place.

(Proceedings interrupted.)

The Court: Back on the record. The testimony in the Container Corporation of America versus the Franchise Tax Board.

And Dr. Mc Donald is on the stand.

I want to thank counsel for their cooperation.

We have to do that sometimes to accommodate the jury.

Mr. Willson: Q. By way of transition, Dr. Mc Donald, could you give us another example that illustrates the difference between "Hurdle Rates" between the United States and abroad for similar investments?

A. Take an example of a copper company that is considering proposed investments in mining operations.

One company with which I am familiar is willing to approve new investments in Montana, for example, which have an expected return of 15 percent after taxes.

But in today's situation in Peru, they are not willing to approve a somewhat similar investment in expanding mining operations there, even though it has an expected return of 30 percent after taxes. The reason being that the risk in Peru is obviously much greater.

The actual return might be in excess of 30 percent, but it could also be negative.

So the "Hurdle Rate" for new investments in Peru is just much higher than for new investments in Montana and the United States.

Q. This is not necessarily the anticipated return in Peru, but simply the minimum return which they must expect to get in order to even consider making such an investment, is that correct?

A. Yes, minimum expected return is exactly what I mean by the phrase "Hurdle Rate."

Q. Have you ever seen a higher "Hurdle Rate" in the United States or similar investments than in a foreign country by the same company?

A. No, I never have. Not for similar investments.

Q. So would you expect that the "Hurdle Rate" would be higher not only on the average in the rest of the world as compared to the United States, but also that for each country the "Hurdle Rate" would be higher than in the United States?

A. Yes, I would. For similar lines of business or similar investments, yes.

Q. So again, are there any places where you would expect a "Hurdle Rate" to be lower than in the United States?

A. No. In my experience, "Hurdle Rates" are higher in every country outside of the United States than they are in the United States.

As I mentioned, the spectrum varies from country to country.

But I would say in every country, they are higher than they are in the United States.

And so for the average of foreign countries, as a whole, or for the average of industrialized foreign countries, or for the average of developing foreign countries, this "Hurdle Rate" is higher than it is for the United States.

Q. Are there any differences in "Hurdle Rates" within the United States? For example, as between California and Alabama?

A. In my experience, there are not. Not for similar investments anticipated or examined by a single company.

Q. Have you ever seen a company that had a higher "Hurdle Rate" in one part of the United States than they had in another part of the United States for similar investments?

A. No, I have not.

The companies that I am familiar with generally apply the same "Hurdle Rate" for specific kinds of business in all of the states of the Union.

Q. Why not? Why wouldn't you expect to find any differences?

A. It is my opinion that the reason for this uniformity for an existing company in a specific line of business throughout the United States just has to do with the great commonalty that one faces throughout the country.

We have a common legal system, and a common language.

The important political risks that one thinks about when one makes investments are generally the same throughout the United States.

It is not to say that there are not occurrences from time to time that may be different from region to region or state to state, but it is simply to say these are not in the same ballpark as the differences one sees when you compare the United States with another country.

And in addition to that, if they do exist, they are not only small in my experience, but transitory. That is to say they don't last. So we see rationale in the similarities with respect to risk.

We can understand this uniformity of "Hurdle Rates" for similar investments by a given company in different parts of the United States.

Q. Do I understand that the basic reason for greater "Hurdle Rates" abroad and in the United States is the differences in risks?

A. Yes, that's correct.

Q. Before we discuss what those risks are, which I would like to come back to, let's turn for a moment to actual rates of return as compared to these anticipated or minimum anticipated rates of return.

That the evidence that companies have a higher "Hurdle Rate" because of the greater risks, is there any empirical evidence that the relationship between risk—that there is a relationship between risk and actual rate of return?

A. Yes, there is. This was a debate in the field of finance and economics that went on very actively in the 1930s and 1940s.

The question was something like this:

Given that there is a higher expectant rate of return for a higher risk, is there also, on the average, and on the whole, a higher actual rate of return that is associated with a higher level of risk bearing?

In the first launched study that addressed itself to actual rates of return and how they related to risks, as I understand the literature, it was a study done by Brad Hickman based on all the large issues of the corporate bonds in the United States in the years 1900 to 1945.

This study was published by Professor Hickman for the National Bureau of Economic Research.

What he looked at were risk categories of bonds in accordance with their ratings.

The highest rated bond is a Triple A bond, and the second is a Double A, and the third is an A, and so on.

It was clear that the promised yield on lower rated bonds, that is high risk bonds, was higher.

And the question that Professor Hickman addressed in his very large sample of time was, was the actual rate of return on this large sample of bonds, particularly after the terrible years of the Depression, when many bonds did default, if not totally, they were slow in their payments of principal and interest, after all of this default experience of the Depression, was the actual rate of return, after all is said and done, still higher for the lowered rate or the higher risk bonds?

From what he found was that after taking into account all of the nuances of this study, that there was an actual rate of return for risk bearing.

That is to say the Hickman results and the debate that followed the Hickman results established that riskier bonds, those are lower ratings, not only have a higher promised yield, but after all was said and done, on the average and on the whole over a series of years, and over a great number of different issues, there was a higher realized return.

So this confirmed the thought that many economists have had, as well as people in business and finance, that people not only expected to be rewarded for risk bearing, but, on the whole they were rewarded for risk bearing.

Q. Is there any empirical evidence in the equities market as opposed to the bonds?

A. Yes. Yes, this evidence came later.

These were studies in the 1960s and in this decade, 1970s, which studied large samples of common stocks in the United States that have been classified prospectively, that is at the beginning of each period, that is as a measure of risk which was somewhat comparable to the bond ratings that had been used in the Hickman study.

And the question again was, after a great number of years, and across a large sample of common stocks, do riskier stocks over time give a higher actual rate of return, given the fact that many of them are companies that get into trouble, and a few of them give negative rates of return.

And the finding of these studies has generally been that on the average, and on the whole, riskier equities, like riskier bonds, give higher actual rates of return.

It is the impression of people in my field of finance that there is, over time, not in every stock, and not in every year, surely, but over a variety of stocks and a variety of years, there is an actually higher rate of return for riskier stocks than there is for lower risk stocks.

Q. Is it reasonable to draw a parallel—you are drawing a parallel between riskier bonds and riskier stocks and the actual returns.

Can we extrapolate from that to an investment in Venezuela as opposed to making an investment in the United States?

A. I think there is a parallel. And I cite the bond and stock studies, because they are in the public domain, and are very large samples of data.

They are studies that have been done by careful research.

In the case of companies, what we are talking about is bonds and stocks are assets in the portfolio of institutional and individual investors. And these project investments, like a copper mine, in a foreign country versus the United States, or a manufacturing operation in Venezuela versus California, is an asset on the balance sheet of a company. So that there is a parallel.

I should emphasize that these rates of return on companies, individual projects, and individual units, are generally taken to be confidential. We simply don't have parallel studies of individual products, actual rates of return versus expected, within individual companies that are directly comparable to the stock and the bond market.

But I think the parallel between the two is positive and unmistakable.

Q. To summarize at this point, you are stating, if I understand it, that when you net out profits and losses on more risky investments, you will end up with a higher net return than netting of profits and losses in less risky investments?

A. That is correct.

Q. Thus, is it your experience that in the normal case, a multinational corporation, it will earn a greater return

in its foreign investments than it will earn in its domestic investments?

A. Yes, I think that is the case. And one should emphasize again that this higher expected and higher actual rate of return is not obtained in every country in every year.

Because if it was higher abroad in every country and in every year, then there would be no risk.

Precisely what risk is, the fact that there are disappointments in some years, and certainly disappointments in some countries where substantial losses are sustained.

But if you aggregate all of the foreign operations of most companies, I should say most financial companies, such as banks, as well, you find that there is a profitability of foreign operations across all countries, an average, over time.

Very often larger than not on the domestic operation.

Q. What are the actual rates of return within the United States? Would you expect to find differences?

A. Yes, I think that actual rates of returns in a given year may obviously vary across operations in different parts of the country.

But this is not to imply that the "Hurdle Rate" or the expected sustainable rate of return should vary from region to region.

Take a simple example. For those McDonald hamburger stands that are owned by the parent company, some of those stores, some of those restaurants in various parts

of the country in a given year are much more profitable than those in other parts of the country in a given year. Indeed, in one part of the city some restaurants may be more profitable than others owned by the company.

But it is often difficult to keep a high rate of return a secret. And either other competing companies, or perhaps even the company itself, is likely to take advantage of those opportunities which look most promising in the short run, and this tends to equilibrate those returns over time.

So the heart of the matter is those actual returns in a given year may vary over various regions of the United States, but it is not the sort of variances that we would expect to last, and it certainly is not in the ballpark, I think, of the kinds of differences that one observes within the United States—between the United States and foreign countries.

One simply cannot compare Alabama and California as you can compare California and Peru.

Q. Those differences that actually occur then within the United States, is it fair to say that they would be short-grown differences, short-termed differences?

A. My experience has been that they are relatively short in term, yes.

Q. And one of the reasons for that would be mobility of capital?

A. I think that is true. Within the United States, with our freedom to travel, and our freedom to move one's person and his family and his machines around the country

as the opportunities appear greater elsewhere, this mobility of human beings and capital, because of the freedom to move across the states, the common language, relatively common customs, and so on, means that if I am earning 10 percent in California, and I think on a similar business I can own two or three times as much in Idaho, I may even move to Idaho, or certainly expand the Idaho operation rather than the California operation.

It tends to equilibrate things.

There was recently an example of a small business down on the Peninsula, where this individual became frustrated over the years because of union problems and higher wage settlements, and higher local taxes, and other problems, and finally just packed up his equipment in his little operation owned trucks, and physically moved it up to Idaho.

This kind of a move one would not expect to be made between the Peninsula and a foreign country very often as people are able to move among the states.

I suppose a more dramatic example would be to move the textile industry out of New England into the Southern states.

This sort of mobility does exist within the United States to a far greater degree than it exists between countries.

Q. Is there any correlation between interest rates which financial institutions would charge in the various locations as between the United States from the rest of the world?

A. Yes, there is.

And I think the way one should observe that directly is to look at interest rates charged on Eurocurrency loans, all of which are denominated in dollars.

Q. Can you tell us what Eurocurrency loans are?

A. Eurocurrency loans, as I speak of them here, are loans that are made by U.S. and other banks out of London, which is the center of this kind of lending, denominated in dollars, and made directly to foreign governments.

Countries may use these borrowings to finance their balance of payments, deficits, for example.

And these interest rates are not reported in the New York Times, but they are in the public record in terms of financial publications.

And what one sees is that the interest rates charged for given maturity of loan by a syndicate of the world's banks to a developing company, the banking system has to take a higher risk, is simply a higher interest rate than that which they charge to the larger industrialized nations.

And I should stress that these loans for the banks are investments. That is from the banks' point of view, the interest rate or the all-end yield is their e[illegible]ed rate of return, and they demand a higher expected rate of return in making loans to Zaire than in making loans to France, for example.

Q. Is the difference only the inflation problems?

A. The inflation problem washes out, because the loans are made in dollars, and the interest and principal is repaid in dollars.

So the relative rate of inflation, which is an important variable from country to country, and which affects the rate of devaluation or revaluation of one concern versus another.

This inflation currency adjustment problem washes out of the consideration, because the loans are made and repaid in a foreign currency.

That is why I used the example of Eurocurrency loans to various countries, so that we can keep it all in dollars, and keep it in a constant currency.

Q. Is there a parallel between lending to foreign countries and lending to companies in those foreign countries?

A. Lending officers of major banks that make these loans feel there is a direct parallel.

That is to say the risks that one sees in lending to a company in a given foreign country are often parallel to risks one sees in lending to the central bank of that country. And the reason is simply because the underlying political situation is so terribly important, both for the perceived risk of the country itself, the ability of the treasury to honor its interest and principal payments on time, and the ability of major companies within that country to honor their promised interest and principal payments on time.

So the underlying factors are those which are political and economic.

Q. You testified as to those Euro market loans.

In your own personal experience, or your professional experience, have you also observed differences in the interest rates at which banks would lend money outside the United States as opposed to in the United States?

A. In my experience, banks generally expect to make more money abroad than they make in the United States.

They pay very careful attention to what they call country risk, and to the amount of loans that are being made, and they are held outstanding in each country.

The reason is that they do business in many, many countries of the world. These countries do differ with respect to their risk exposure.

Banks do suffer losses from time to time, and these riskier loans are not honored.

And the most recent examples are the defaults in Zaire and the defaults by the Turkish government. And because of this, banks keep very careful track of the expected and the actual returns that they are making in terms of these interest rates in various parts of the world.

They view them as being more profitable in an expected sense, but they also perceive them as being riskier.

Q. And they charge higher interest rates abroad than they do here?

A. Yes, they do. And particularly after you adjust for differences in exchange rates so that you get a comparison of apples and apples.

That does not confuse loans in Brazilian cruzeiros as compared with loans in American dollars.

That is, you must keep it in a constant comparison.

I think they do apply both to businesses abroad and to loans to the central banks, to the countries themselves.

Q. Are there parts of the United States where you would expect banks to charge a higher interest rate than in other parts of the United States to a similar company?

A. Banks regard the United States as a national market. And larger banks that do business in many parts of the United States have a single prime rate which is quoted in the paper every day.

Now 8 percent, which they extend to the highest quality borrowers, whether they be in Detroit or in San Francisco or in New York or Atlanta.

So we do have a national market, and there is for companies, I should stress, of the same size, same credit worthiness, the same interest rate, regardless of their geographic location.

Q. You testified earlier that the basic reason for these greater "Hurdle Rates" in foreign countries is because of risk, is that right?

A. Yes, risk is the central factor.

Q. Could you categorize what these risks are?

A. Categories of risk are often taken to be arbitrary, in the sense that different individuals will clarify the risks in slightly different ways.

But generally speaking, there is broad agreement what these risks are, although the language used to describe them, they obviously differ from person to person.

I think there are three very large categories that most banks think about and most large corporations consider.

Those are catastrophic first.

And second, risks associated with economic state.

And, third, political risks broadly defined.

Q. Let's take a look at those individually.

Perhaps we should start, and if you can explain, what are the catastrophic risks?

A. The catastrophic risks are fundamentally politically rooted in nature. Companies worry. Latin American companies worry in particular about expropriation.

The experience of the American copper companies in Chile, that is a prominent example that will not be forgotten in our generation.

And smaller companies than that have been nationalized or expropriated, as well.

What we are talking about here is involuntary loss of ownership or control, or both, without payment for that expropriation. That is the unilateral or highly restrained negotiations, so that you do not get paid the total market value of your investment, and you are taken out against your will.

So catastrophic, in the sense that it tends to end the business as it was envisioned when you went into it.

Q. What about your second category, risk, what economic state?

A. By economic state, I mean that the economic make-up of countries does differ just enormously across countries, as compared to the United States.

The striking thing about the United States is not only that it is so large economically, but that it is so diversified. So many different kinds of products and industries.

As you go to much smaller countries, these countries very often are dependent for their balance of payments for their exchange earnings on a small number of products.

For example, Peru depends importantly on the exportation of copper and fish. And many of the anchovies are simply not there as they were some years ago.

Similarly, Zaire is in trouble today because of the low price of copper, as well. These are not well-diversified economies.

They may have a lot of people with good will in the countries, but they are subject to buffeting of commodity price and other economic changes, many of which are beyond their control, and these changes don't get averaged out the way they do in a larger economy.

So by economic state, I think about the size of the economy, economic diversity of the economy. Those things which constitute the whole portfolio of the activities in small countries as opposed to larger industrialized countries.

Q. What about devaluation risks, are those economic state risks?

A. Yes, I think that one can consider currency changes as part of the economic picture. What devaluation or

revaluation simply refers to the changes in exchange rates as between any two currencies.

For example, between the Zambian kwacha and the United States dollar.

Q. Your third category of risks with political risks, will you elaborate on those?

A. Political risks range from the catastrophic, the ones that make the newspapers from expropriation, down to many kinds of political risks which are much more day to day and much more less dramatic, but certainly no less real for the companies that have to do business there.

Many have to do with restrictions on business. These are not unknown in the United States, to be sure, but they are much more complex and much more difficult to predict often in foreign countries.

I am thinking of the tendency of many foreign governments to change the rules of the game once companies are in under a given set of rules that may have appeared to be quite a reasonably profitable investment.

Under a new set of rules, under a new regime, it appears to be much less profitable.

By "rules of the game," I mean the whole set of restrictions and guidelines under which a business operates.

To be specific about this, they might involve various kinds of controls, price controls, for example.

Q. Price controls is what you mentioned?

A. Yes.

Q. What do price controls mean?

A. Price controls are simply the control or the influence that governments and regulatory bodies have over prices of various kinds of goods and services as opposed to letting the prices be set by the free market system.

Price controls are not unknown in the United States even today, but they are much more generally imposed abroad, and much less predictable in my experience in many foreign countries than they are in the United States.

A second category, perhaps even more trouble than the first category of restrictions, has to do with restrictions on labor and the policy towards employees, and the way policy towards employees is handled in many countries.

For example, in many foreign countries, it is much more difficult to layoff employees in a period of slack and recessions than it is in the United States. So there is a constraint on the ability of a business to cut back its operations when it would seem financially desirable to do so.

In addition, it may be difficult for companies in some countries to terminate employment, or even to shut down an operation and pull out all together without the permission of the government.

Plant openings, plant closings, plant movings, many of these decisions which are taken to be the domain of the business management in the United States are highly restricted by governments in other countries.

I think the second major category has to do with the constraints on labor and other kinds of employees.

Q. Are there any other restrictions, repatriation problems?

A. I think a third category does have to do with restrictions on the remittance of earnings to the United States. These rates of returns that are earned abroad often are not convertible immediately into dollars and able to be repatriated to the United States.

Many countries have restrictions on the percentage amount of earnings that can be repatriated.

And for those earnings that are left within the country, often they have restrictions on how they may be reinvested.

So the returns once earned are not so freely directed from foreign operations as they are from the domestic operations.

Q. You mean by that you may actually earn money in another foreign country and not be able to get the money out of the country back to the United States?

A. That's correct. One might earn, one might invest a hundred dollars and earn fifteen dollars in income, and find that they can only repatriate two of those dollars, for example, to the United States, and that the remaining thirteen could only be reinvested along the lines of rules set up by the government.

So it is not true that a return is a return. It depends where it is earned and what the constraints are, and what you can do with the money.

Q. Any import restriction differences recognizable as between imports into foreign countries and into the United States?

A. Many foreign countries have restrictions on imports and have tariffs that are much more extensive and much more complicated, and often far larger than those in the United States.

It is not unheard of to have tariffs of 300 percent on the importation of machinery. For example, to a foreign country, machinery which might be used to replace labor, so-called labor-saving investments. Simply it is the desire of the people in those countries to try to sustain employment for those people who are now working.

So I think there is a whole complex of restrictions which the people who run foreign country governments see as being in the national interest, which may conflict with the best interest of the American companies who seek to do business there.

Q. The Stipulation of Facts in this case, on page 65, and paragraph 130, comments on this, CCA's own experience, mainly governmental involvement in plant location, capacity expansion, wages, and worker participation in decision-making, and so forth.

Does your own experience bear out, confirm with the experience related in the Stipulation of Facts?

A. Yes, it does. I was not all surprised to read those facts.

Q. Are there any differences in the risks within the United States?

A. Yes, I think there may be differences from time to time and region to region, but they are not in the same ballpark as the larger differences so often existing between the United States and foreign countries.

So that the order of magnitude of the risk differences between countries, and the United States and many foreign countries, is simply larger than that between states.

Also, it is my experience that whatever risk differences do exist among regions of the United States, that these risks are often transitory in their difference. They are simply are not by the events as they evolve.

It is because we are basically, with all our differences, one great United States, a single country.

Q. Would the situation ever stabilize within the United States, in your view, with risks higher in one region than another?

A. I cannot imagine that it would.

Q. You testified earlier that the textile industry moved out of New England and into the South. Doesn't that indicate that greater return must be higher in the South, and we could expect it to permanently be higher in the South?

A. I think the answer is yes and no.

It exists that the rate of return on operating in the South is sufficiently higher to warrant the move out of the New England states.

But note how the adjustment process works, and I think the textiles are regarded as a classic example of regional change.

The movement of companies from the North to the South has served to bid up wages in the South. Bargains in land are more difficult to find now than they were before.

And so I would imagine many of these textile companies both expect to and did realize higher rates of return in the South than they did in New England. But the very active mobility of this capital, the movement of these enterprises has tended to drive down the realized rates of return in the South as the price of land and wages, and so on, is bid up, and to make New England relatively more profitable.

And it is because of this that there are some examples lately of companies moving to New England because of the situation now in wages and in land values that now look more attractive.

This process has been going on for a very long time in the United States, and I would expect it to continue.

Q. You testified in talking about political risks a lot of those risks seem to come down to differences between the makeup of the government, the people, and the system.

If that is true, why then would we have a different risk situation as between Great Britain and the United States, Great Britain having a similar democratic tradition, and so forth?

A. I think there are many similarities between Great Britain and the United States. The most obvious ones have

to do with language and the parliamentary system of government, which are so similar in many respects.

Great Britain is not a place where you can expect to find the kind of fighting in the streets that one observes in some of the developing countries.

That is it is a system of law and order similar to the United States in many respects.

But there are differences that I recall, jointly political and economic, that are profound between Great Britain and the United States.

The struggle between the two major parties in Great Britain and the nationalization of so many major industries in Great Britain, I think the steel industry is the best example, has induced in the British system a great deal of uncertainty about what the future for Great Britain will hold.

Many of those risks that were foreseen for Great Britain have been reduced a little bit by the inflow of oil from the North Sea. But that great country has in its political consensus many aspects of uncertainty about the Britain of the future that the majority foresees.

So that while there are many similarities between the United States and Great Britain, I think there is less a consensus in its political economic sense in Great Britain than the United States, and it is because of that, and the labor situation being somewhat more difficult in Great Britain than the United States, that one saw for so many years the refusal of American firms to invest in many

cases in any more money in Great Britain until the situation changed.

So it is not a criticism of the whole great country of Great Britain, and it is not in any way an attempt to paint them with the same brush as Peru.

When one says there simply exists in Great Britain, because of its political-economic situation some risks that do not exist in the same extent in the United States, they are comparable, but they are not identical.

Q. Are there any other reasons for the higher "Hurdle Rates" internationally than in the United States other than risk?

A. In my experience, risk is the heart of the matter.

Businesses talk about these differences in a language that varies just enormously from business to business. They talk about strategic considerations. They talk about motivation of securing market shares. The language may be that of marketing, or production or finance.

People talk about it in very different language.

And often, in my experience, it really comes down to risk in the end. That is, the way it is described may vary enormously. But the differences that are implied by higher "Hurdle Rates" abroad as opposed to the United States really come down to these fundamental differences in risk, which have to do with political and economic structure.

The Court: I am sorry. When you get to a logical area here, I do have a matter with the jury, and I want to give the court reporter a few minutes.

Mr. Willson: Just a couple of minutes.

The Court: All right, fine.

Mr. Willson: Q. Did these international risks, differences, exist in the years that ensued in our case, 1963 and 1965?

A. Yes, I think they did.

Q. Any differences?

A. "Hurdle Rates" were higher abroad ten to fifteen years ago as they are today compared to the United States.

As I stated earlier, there have been changes from country to country.

I mentioned, I think, decreased risk in Germany of investments, vis-a-vis the United States, and Japan, vis-a-vis the United States, and the increased risk in investments in certain Latin American countries with political and economic problems.

So the basic spectrum existed then, as it does today, but there are differences from country to country.

The spreads may narrow or widen, but the basic structure existed then as it does today.

Q. How long have these risks conditions been going on, the differences in risks?

A. I think that they have certainly existed for a very long time.

Obviously if you go back a century or two, you have a situation where the United States was a developing country and Great Britain was a great industrial power.

It is just likely in the 19th century the situation could have been reversed. So I don't mean to imply that it was ever thus, but rather over the great part of the century, certainly during World War II, these broad relationships have held.

Q. So you suppose in some period of time that the positions of Great Britain and the United States have switched in terms of which is the less risky place?

A. I think they have, as the population has grown in the United States and surpassed Great Britain, and we now have what we call the Gross National Product, which was not a phrase used in the 19th century. It has grown in the United States and surpassed Great Britain. The two countries have crossed in terms of size and importance.

And in the structure we are talking about today, one could have said a hundred years ago, or a hundred and fifty years ago, that the reverse could have been true in terms of "Hurdle Rates" being lower within Great Britain than they are in the United States as a young country.

Mr. Willson: This is a good place to break, your Honor.

The Court: All right, fine. It will take about ten minutes or so, and you may step down, Doctor.

(Proceedings interrupted.)

3:53 O'CLOCK P.M.

The Court: Now we take up the civil case again.

I believe, Mr. Willson, you stopped off your examination when you were talking about the year '63 to '65 where the "Hurdle Rates" were higher today.

Mr. Willson: Q. On risk conditions, Dr. McDonald, you testified that they have been going on for a long time, the differences in risk between the United States and other countries, is that right?

A. Yes, it is.

Q. And you expect those differences and risks to continue into the future a long time?

A. Yes, I do.

Q. Do you expect those differences and risks to be worked out in our lifetime?

A. No, I do not. I would think that it is fairly clear that between now and the end of the century it will continue to be substantial risk, there will continue to be substantial risk differences between the United States and the total economy, the foreign countries we are talking about today.

Q. Do you expect the actual rates of return, differences in rates of return will continue for a long time into the future?

A. Yes. I think we can realistically expect that companies doing business in the United States and abroad will continue to earn on the average and on the whole higher rates of return abroad than they do in the United States.

That is to say that not only will we expect rates of return to continue to be higher in foreign countries than they are in the United States, but that average actual rates of return will continue to be higher, as well, in foreign countries than here in the United States.

Q. Is it fair to say that in your view more rational businessmen would invest in a foreign country with an expectation of a lower rate of return than he could get for a similar investment in the United States?

A. Yes, I think that is correct. I think no rational businessman would invest money abroad at higher risks and lower return, provided that rate of return was realistically calculated over some long time horizon over the life of the entire project.

I think it is just simply not the everyday rational business decision to invest money without getting paid, hoping to get paid on the average for the risk that you will have to bear.

Q. You have testified that the "Hurdle Rates" are higher in the rest of the world than they are in the United States for the reason that the risks are greater in the rest of the world than in the United States, and also the companies have been, and you expect they will continue to achieve greater rates of return abroad than they achieve in the United States, is that correct?

A. Yes, that is true on the average.

Q. Let's turn to how these greater rates of return are actually achieved.

And I wonder if you would tell us what the major reasons are that enable companies to achieve greater rates of return in foreign countries than they achieve in the United States?

A. Well, the number one factor has been lower payroll costs in foreign countries than has been the case in the United States.

Wages in the great majority of manufacturing industries and a per hour, on a per year basis, are lower abroad than they are in the United States.

And you add into that fringe benefits so as to get the total labor cost again on a per hour or per employee year basis.

And a great majority of industries and great majority of countries, these wages are simply lower abroad than they are in the United States.

Q. Don't you expect that the workers abroad are generally less efficient and less productive than workers in the United States?

A. That is true. They are generally less efficient than they are in the United States, in the sense that it takes more labor hours generally to produce a given unit of output abroad than it does in the United States.

This lower efficiency abroad than in the United States tends to reduce the difference between the lower wages abroad and in the United States in terms of what businessmen normally call unit costs.

Unit costs is the total labor cost per unit of output.

But despite this difference in efficiency, the fact remains that unit costs in the great majority of industries in great majority of countries are lower abroad than they are in the United States.

Q. What differences might you expect to find generally between foreign and domestic operations which are a result of these lower payroll costs abroad?

A. In my experience, the basic common sense of most businessmen is that where unit labor costs are higher, there is more pressure to automate. In general, there is more pressure to use machines and automated process than to replace labor.

And on the contrary, when the reverse is true, where unit labor costs are relatively lower, there is a tendency to try to use labor rather than machines, or use labor plus lower technology, older machines rather than labor plus high technology machines, as is generally the case in the United States.

So the point of all this is that the production process and the combination of workers and machinery is, in part, determined by wage costs.

And so what one finds is in countries with much lower labor costs, there is a much more labor intensive design of the work process.

It really affects the way the business is set up in the first place.

Q. We are talking here about how it is that businesses achieve greater returns, and you testified the lower payroll costs is the first and primary factor by which they achieve great returns in foreign markets than they do domestically.

What other factors are there?

A. I think businessmen often talk about the inputs in industry, protection they sometimes get in foreign countries.

We talked earlier about the restrictions which are of political or economic nature that countries sometimes place on the businesses which are within their frontiers.

On the other hand, there are sometimes some benefits which they bestow in terms of these barriers of keeping out the kind of free competition that normally you would be exposed to as a business that is already there.

So the infant industry protection notion, which is really, I suppose, in origin an economic phrase as much as a business phrase, and is a notion that it may be viewed as being in the national interest of that country to have a given industry so that they will be more autonomous as opposed to simply importing that goods, and to nourish the so-called infant industry along, and they will set up protection barriers that enable that business to do better than it otherwise would in getting started in the total exposure to the winds of free competition.

So this serves to enable those people who are there to do better than they might do with full competition.

Q. Is an additional factor that the economies in these foreign countries are often growing at a faster rate than in the United States?

A. When you look at growth and demand for the product, that depends, in part where business in general in

a country, are the real growth of the economy. I mean the growth of income and output in that economy after you adjust for inflation.

And the fact of the matter is that developing countries are in a stage of their own growth which is at a higher slope of growth than for industrialized countries like the United States.

And many places with higher real growth enables companies to sell into a demand for higher growth of product, which leads to not only higher profitability, but higher growth in that profit path, as well.

In the language of business, I often hear businessmen talk about the real growth potential abroad as opposed to the United States, that is higher growth in foreign markets versus domestic markets as one of the ways by which these high rates of return that they expect might be realized.

Q. What about, I often hear that businesses will have a larger share of the market in a foreign country than they will have of the market in this country. Is that a factor?

A. It is generally a factor, yes. Market structure, market shares vary a lot from industry to industry, as well as from country to country.

But if one can be generalized, I think it is that in many smaller countries, and, again, less diversified than the United States, companies in a given industry, in that stage of the country's development, are able to build up and

retain a larger share of the total market than they might be able to in the United States.

And the feeling among many businessmen is that a higher market share leads to a higher profit margin and to a higher return on investment.

Market structure or share is part of the anatomy of the production of profits through which returns are achieved and realized.

Q. If you had in a particular foreign country highly competitive conditions so that it was easy for a new investor to get into a particular industry, and you did not have as large a market share, would you still expect that the actual returns would be greater in the country?

A. Yes, I would. And it is a key point, I think.

Because the question that I often hear in business is under free competition, that is without this sort of protectionism that I spoke of earlier, would it be the fact that new entries in that market and additional competition would bring these rates of return down so that they might be no higher than they are in the United States?

And I think the answer is that even under free competition, this would probably not occur. That is, the conclusion is that because of the higher risks for all the economic as in political reasons we have already discussed, in foreign countries as opposed to the United States, that the entry of new business, the entry of new businesses into that market, would stop short of the point of driving returns down to the level that generally one would find in the United States and in lower risk areas.

So the way I would express it is that, even under competition, you would get to a kind of unequal, where greater returns are both expected, and, on the average, actually realized in that smaller, less-developed country, than they would be in the United States in a similar industry.

Q. Dr. Mc Donald, you have reviewed, have you not, what is called Stipulation re Testimony?

A. Yes, I have.

Q. And as part of that, you have reviewed the testimony which would have be given, or it is there, of Thomas Kucharvy, and William Lee and Harry Green, which are the three individuals named in that Stipulation re Testimony, is that correct?

A. Yes.

Q. With regard to the testimony of Harry Green, which is Exhibit 3 to the Stipulation re Testimony, would you say that his indication of "Hurdle Rates" and anticipated rates of return used by Container Corporation is comparable to what you would have expected and comparable to what you have been testifying to?

Mr. Plant: Your Honor, at this point, to make the record clear, the Franchise Tax Board would like to register a continuing objection, if possible, to any testimony given by Dr. McDonald to support the matter set forth in the Stipulation re Testimony, for the very same reasons that we have set forth in the preamble to that stipulation, and with agreement of counsel and the Court, not consent, and we would like to address any arguments as to relevancy

and materiality in our briefs, not only to the matter set forth in here, but any testimony of Dr. McDonald along the same line.

Mr. Willson: Agreed.

The Court: I think that would be well noted.

The Court will accept the testimony at this time, but in the event the objections to certain testimony in the Stipulation re Testimony were sustained, then the Court would review Dr. McDonald's testimony in that light; to wit, a premise upon which he made a statement based on Mr. Harry Green, Dr. Harry Green's testimony as to weight or other reasons, if the Court sustains the Franchise Tax Board.

Mr. Plant: Thank you.

The Court: The same is to the opinion of any other expert; to wit, if there is a basis of fact supported by the evidence.

Mr. Willson: Should I restate the question?

The Court: Do you have the question?

The Witness: Please restate the question.

Mr. Willson: Q. The question is, in having reviewed the statement by Harry Green, namely that "Hurdle Rates" are defined by him to be the minimum returns which must be anticipated before an investment will be made, and also he discusses, he contrasts that with reasonably anticipated rates of return which are higher than "Hurdle Rates," since "Hurdle Rates" are defined as a preliminary rate of return, and he states there during the years in question

CCA expected the domestic operations to yield, and after tax return on investment, between ten and twelve percent, and the overseas operations to yield, and after tax, return on investment of between eighteen and twenty percent.

And my question to you is, is this comparable to what you would expect and to what you have been testifying to?

A. Yes, it is.

My experience in relationships with other American companies is similar with this statement in many respects.

Above all, there is a higher "Hurdle Rate" for a foreign investment than domestic investment.

And secondly, that the anticipated return, that is the average return you hope to make is somewhat above the minimum or the "Hurdle Rate" in both cases.

So I think the relationship generally holds in the companies with which I am familiar.

Q. Exhibit 1 to the Stipulation re Testimony is Mr. Kucharvy's testimony. And there are a series of schedules attached to his testimony.

And, for the record, Dr. McDonald has a copy of those schedules with him, and I would like him to refer to those schedules.

Mr. Plant: No objection.

Mr. Willson: Q. As to Mr. Kucharvy's testimony in the schedules, how do they define or measure profitability of these operations?

A. The basic bottom line measure of profitability is return on investment.

The return on investment, once again, is a measure of profit divided by a measure of the investment base. It is the ratio we have been discussing here today.

Q. Is that the generally accepted way to calculate return on investment?

A. I think it is the generally accepted way of calculating return on investment.

I should emphasize once again that there are many variations on a theme. Both in the definition of profit, in the enumerator, and in the specific definition of investment base in the denominator.

I think the important aspect of my experience has been though not the variety of variation on a theme, but the general similarity that it is a measure of profitability in the enumerator investment base, in the denominator and the motivation in the use of this ratio is to determine profitability per unit of investment.

Q. Mr. Latcham tells me I said Schedule 1, and I meant Schedule 6.

I take it you are referring to Schedule 6?

A. Yes, I have been looking at Schedule 6, and I have been referring to return on invested capital or rate of return on Schedule 6.

Q. You just testified that there are some variations on this theme in terms of how you might define invested capital or define profitability.

If you make those variations, or adapt some of those variations, is it fair to say that as long as it is done consistently, you would anticipate whatever ranking it gives you to be the same?

A. Yes, I think that is the heart of the matter. Whatever ratio definition you use applied consistently within the company, that is that a comparable set of numbers would be used in calculating the profitability across different segments of the business.

So that while many companies vary in their definition, all the ones with which I am familiar try to stick to one measure once they come up with it, and apply it consistently in different parts of the business.

Q. All right. If we could take a look at Schedule 6 now?

What do those figures demonstrate? How should we interpret those?

A. In my judgment, the most striking inference that I would draw from these numbers on Schedule 6 is that the average return on domestic investment over these three years was 13.1 percent, whereas the average rate of return on foreign businesses over the same three years was 17.2 percent.

That is to say that the actual average rate of return achieved on foreign businesses was higher than monetary percentage points per annum than the rate of return on the domestic business.

Q. Is the difference between 17.2 percent and 13.1 significant, would you say?

A. I take it to be quite a significant difference. It is a percentage term of one-third higher, nearly, abroad than in the United States. And four percentage points per annum is a very substantial number, indeed, to a finance man or a businessman.

Q. Turning to Schedule 7, which calculates return on average invested capital for the six operating countries, and what do we find to be instructed there?

A. I think the key findings that I would draw from Schedule 7 is that the return on invested capital in the United States was basically more stable over these three years than it was in any of the foreign countries in which the company had operations.

You see that only Venezuela had a higher rate of return than the United States in every single year, but that is what you would expect. That is precisely what higher risk normally means.

Sometimes it is higher in the United States, and sometimes lower than the United States, but, on the average, you expect it to be higher.

And I think that that shows the relationship between the numbers in effect on Schedule 6 and 7, in the sense that Italy, for example, a lower rate of return than the domestic return.

Germany had an average rate of return over these three years which was approximately equal to the domestic return.

The other four operating countries had average rates of return that were higher than the United States.

The total for all six of the operating countries averaged over the three years was higher than the United States. That is this number of 17 versus 13 percent.

So this serves to emphasize that it is the average foreign operation and the average over the number of years that one would expect to be higher.

If it were always higher abroad, then there would not be the higher risk that we talked about this afternoon.

So I think averaging over time the number of years, such as this three-year period, and averaging over a number of foreign operations, is just fundamental common sense, as most businessmen would see it in trying to understand this relationship between risk and return between foreign and domestic operations.

Q. Schedules 1 to 4 relate to a single aspect of CCA's business for the year 1974, not for the years ensuing, in that they compare the corrugated operations, the corrugated container plants in Cali, Colombia, with the corrugated container plants in California.

In looking at those schedules, Professor McDonald, what can we learn about why the returns that you previously testified to were higher for CCA's foreign operations than their domestic operations?

A. I think the breakdown of data in Schedule 1 and 2 show three or four major items that contribute to this

higher realized return in this example of comparing Cali, Colombia, to operations in California domestically.

The first item that strikes me is on Schedule 2, line 7, which shows the labor cost per man hour for the average California plant as opposed to the plant in Cali, Colombia.

And we see that the average labor cost per hour is six times as high in California as compared to Cali, Colombia.

Then on the next line you see the labor cost per MSF, which is the unit labor cost per thousand square feet of output.

And you see that that number is roughly two and a half times as high in California as it is in Cali, Colombia.

The difference between that two and a half and the six is simply the effect of productivity that we were talking about earlier.

Wages, per se, are only one-sixth in Cali as to what they are on the average in California, but the California laborers are more productive and more efficient when combined with their machinery.

So the net of that is that the unit labor cost per unit of output is still more than twice as high in California as it is in Cali, Colombia.

I think that the payroll item I just mentioned is the most striking.

I think a second item, which is also important, is shown on Schedule 1, line 3, and that is the sales price.

The sales price per unit is higher in Colombia than it is in the United States.

And looking down the same page, you see on lines 4, 5 and 6, that the material cost, that is that the input materials to the production process are also more expensive in Colombia than they are in the United States.

So that the net of those two, is that their material cost is higher, and the sales price that they sell it for after processing it is higher, as well.

The payroll and sales price and material costs are the first two items.

The third item is depreciation. You see that on Schedule 1, line 11. These fixed plant charges are the sum of depreciation insurance and some other fixed charges.

But the key finding here is that depreciation and other fixed charges in Colombia is only one-half of what it was in California.

I think that is illustrative of the situation of using the older machines or fewer machines, less capital intensive process or labor intensive process than one would find in California.

So that lower depreciation charge, the lower production price in Colombia tends to give a higher return, as does a lower labor cost.

And the final item I think is the line 12, Schedule 1, which shows what they call fixed corporate charges.

I take this to be the corporate overhead to the two operations.

It seems to me to be stated quite conservatively, in the sense that they allocate more than twice as much overhead to the Cali, Colombia, operation per unit of output than they allocate to the average California operation.

Well, the sum total of all four of these factors that I mentioned, which are payroll, sales and materials, depreciation, and other fixed charges, and fixed corporate charges where overhead is to produce a higher profit per unit in Colombia than is produced in California.

This line profit for income tax is seen as line 16 on Schedule 1, and this number works out to be 4.61 for Cali, Colombia, versus 2.97 for California.

That is the sum total, if you like, of all these differences in prices and costs.

Then when you divide profit by invested capital to get return on invested capital or rate of return, you see that the combination of all these factors leads to a higher return on invested capital in the foreign operation and in the average operation in California.

Q. I want to emphasize that the figures on this schedule you have been talking about are for 1974. The years in suit here are the years 1963 through 1965.

Exhibit 2 to the Stipulation re Testimony is a statement by William Lee that he believes that if these comparisons could be made for all the corrugated plants for the years 1963 to '65, the differences in productivity, hourly labor costs, and unit labor costs, would be at least as great, and probably greater than those shown for 1974.

Based on your experience, would you expect that that is correct, namely, that the differences in magnitude on these items would be as great in the year '63 to '65 as they appear to be in the year 1974?

Mr. Plant: Your Honor, I would object to that as being outside of the scope of the witness' expertise.

I believe that the figures generated in this schedule are based upon accounting procedures, it involved variables, some of which I believe it is recognized herein or admitted, which would render it almost impossible for Dr. Mc Donald to say with any degree of certainty what the situation might be peculiar to CCA's operation for the period in controversy.

The Court: Mr. Willson?

Mr. Willson: Well, I would like him to answer the question, and I think it is within his expertise. He is a man who spent a great number of years analyzing financial data. In the large measure, that has been his living.

He has analyzed the data here, and I am asking him to extrapolate from 1974 back ten years earlier.

Mr. Plant: We do not question his ability as an expert in foreign investments. We question his familiarity with specific accounting procedures, and his knowledge of specific variables, which may or may not have been taken into account in this particular schedule which would reflect in one way or another which he could not foresee, the figures that might be compiled if they were available for the earlier period.

The Court: I will overrule the objection.

Mr. Willson: Q. Would you like me to rephrase the question, Professor?

A. Yes, please do.

Q. There is testimony in Exhibit 2 of the Stipulation re Testimony of William Lee.

The Court: So that it is clear, this is subject to the same considerations I made regarding Dr. Green's testimony, and any finding on your objections on that. The objection is that it goes to the weight, basically.

Mr. Willson: Q. That Mr. Lee and other officers of CCA believed that if these comparisons could be made for all the corrugated plants for the years 1963 to 1965, the differences in productivity and hourly labor costs and unit labor costs would be, at least, as great, and probably greater than those shown for 1974.

Based on your experience, would you also anticipate that if the data were available and were calculated in the same way that it was calculated in these schedules that you have reviewed, that the differences in productivity for the years '63 to '65 would be as great as for the year 1974?

A. Yes, I would expect them to be exactly as you have described them, and let me say why.

It is because the key differences here have to do with differences in payroll.

Wages have been rising in the United States, and even rising in most foreign countries, as well.

But in Cali, Colombia, as a developing country, I think it would be my strong inclination to believe that wages have been rising there at least as fast, and that is what "developing" means, catching up.

They have been rising at least as fast in Colombia as they have in the United States over the last ten or fifteen years.

So with respect to this key payroll variable which drives the unit labor cost, derives a difference abroad versus the United States, I would be inclined to think that these differences which lead to higher profitability abroad than in the domestic market would have obtained, as well, ten or fifteen years ago as they did in these numbers in 1974.

And this is based not on any special knowledge I have of this company in those prior years, as I take it those data are not available, but rather looking at a lot of businesses in the United States and abroad over a period that we are talking about here.

It is a sensible finding, in my judgment.

Q. Cynics sometimes suggest that figures can be made to show anything, and that there are a lot of assumptions, some of which may be arbitrary, that go in calculations, including calculations like these.

After your analysis of these figures, do you regard them as being conservative in showing a higher rate of return in Cali, Colombia, than in California?

A. I have looked through these numbers, and I take them to be conservatively stated, based on the data I have before me here.

And I would cite one example which strikes me as relatively conservative. And that is the allocation of more than twice as much of overhead to the foreign operation as to the domestic operation per MSF of output.

What these basically relate to is taking overhead, which relates to the operation of those foreign businesses, overhead that may be incurred here in the United States, and allocating that out as well on top of Cali's own overhead.

This tends to reduce the profitability from what it would otherwise have been if they had been allocated the same amount of overhead. It is still higher there than here.

I mention that as one example of relatively conservative order of magnitude in the two to one relationship in the allocation of fixed corporate charges.

Q. Is it fair to say that you spent a large amount of your professional life in determining ways to measure the amount of income earned by a particular corporation?

A. Yes, that is true.

Q. Are you familiar with the way businessmen would measure the particular income that would be earned by a particular unit of the business?

A. Yes.

Q. Have you seen a variety of methods by which the calculations would be made, for example, the calculations of how much income a company earns in a particular country?

A. Yes, I have.

Q. I would like to give to you a hypothetical way of making that calculation.

Assume that you had a business operating in California, and one operating in Indonesia, and that the way the calculation was made was to—let me start again.

These are in the same line of business, but you do not find a significant flow of products back and forth. And the calculation is made this way:

You take the total income of the operations in California and the operations in Indonesia, and that is your total net income figure;

You apportion that income to California on the basis of the three-factor formula, the factors of property, payroll and sales, and they are all equally weighted factors;

And the way you make the calculation is that you put into the numerator of the fraction the payroll in California, and the denominator of the fraction, the payroll in California and Indonesia.

You do the same thing with the property, and the same thing with payroll—with sales, and you average those three fractions together.

You then get the percentage attributable under this theory to the state of California;

You then multiply that percentage figure by the total income earned both in California and Indonesia.

Do you understand the formula I have just described?

A. Yes.

Q. Is this among the formulas that you have ever seen businessmen use in attempting to determine income from their operations in a particular foreign country?

A. No, I have not.

Q. Can you imagine or envision a circumstance where businessmen would use this formula?

A. No, not in the real world of business.

Q. Why not?

A. I think there are several reasons.

The first reason is that in my experience, businessmen would not use a surrogate or a proxy method of calculating the bottom line profit when it is possible to go directly to it by more traditional methods. That is to say this hypothetical system that you described to me just might give you an answer which is consistent with the businessman's calculation of profitability, but it certainly might not.

It would be only incidentally the same item, I would think.

And secondly, with any kind of a surrogate or proxy measure like the one you described, the key thing, in my experience, would be the relationship between the surrogate and the thing you are trying to measure.

The key thing here is what is the relationship between sales and profit, and what is the relationship between their payroll and profit? What is the relationship between property and profit?

It is only when all of these factors in the surrogate measure are proportional to the profit as the businessmen would have calculated on the bottom line that this surrogate measure will give you the same result.

It is a rather roundabout way of doing it as you described it. This would be my experience.

Q. Would you expect the true income picture as you would see it, as businessmen would see it, as economists would see it, would be distorted through this formula applied through the international arena?

A. Yes, I would think in this example of California and Indonesia, I would think it would be distorted.

Q. Could you give us an example that would demonstrate why?

A. Let me take a simple example of a company that only has two divisions, one in California and one in Indonesia.

Let's assume these divisions are the same size, to make it simple. And let's say that the property that each of these companies has after initially building these plants is identical, to hold that factor constant.

The two divisions produce a product. They sell it during that year, and the volume of output is the same from the

two plants, and the price they sell it for is the same, to make this a simple example.

Sales in Indonesia are ten, and sales in California are ten.

So what I will do now is think of a simple example of a profit and loss statement, with just the essential factors in that profit and loss statement, starting with sales, which is the top line of an income statement on the top row, 10E.

Let's assume the payroll for a minute, total labor cost in California is four per year, and in Indonesia is two per year. The labor cost is half as much.

And the next line on the expense cost picture is an item in which you lump together all the other costs of the operation.

And let me assume that the company uses accountants and economists, and people of old-fashioned business common sense together to try to decide how to apportion all the common costs between the two operations.

The company has one president, one board of directors, and you have to by some way find how to allocate the cost part to operation and part to the other.

Let's assume for the minute economic and accounting and other factors have been brought to bear, and they have used the best common sense, and it turns out to be four for California and four for Indonesia.

Going down the profit and loss statement, what it looks like is Indonesia sales ten, labor two, all other costs four, and the net profit on the bottom line would be equal to four.

In California, it is sales ten, labor costs four, all other cost and expenses four.

So the bottom line profit would be equal to two.

So the sum of this little example is that the total profit of the company would be four plus two, or six, as we calculated it on the bottom line.

Now as I take it from the hypothetical example in this formula that you have just given me, if you applied this formula to apportion the total profit of six, the result would be just backwards, that is, you would take the labor costs, which is twice as high in California as it is in Indonesia, and you apportion twice as much profit to California. That is you apportion four to profit in California and two to Indonesia.

The reverse is true, the reason it is higher profit in Indonesia in the first place is because of the lower labor cost in this example, where sales and property are held constant.

And the effect of the allocation based on labor is to get the profit allocations backwards.

So the total of six was four abroad and two in California.

And the apportion formula would give the opposite. Four in California and two abroad.

Why does this make a difference? Because the businessman is trying to get the profitability right so that he can figure out where to invest his next dollar.

And by the apportionment formula, it looks like California is the profitable operation, where common sense tells you the foreign operation is the profitable operation, and that is the place to put the next dollar of invested capital.

The profitability appears to be twice as much by business common sense abroad than it would have been by this surrogate measure.

So the sum of this is that the surrogate would not work very well at all, vis-a-vis the reality of this very simple example.

Q. If you took this formula and applied it to your hypothetical where you were using just payroll as the apportionment formula and you found—would you expect that a businessman—the use of a formula would indicate that the profit was doubled in California than it was in Indonesia? You would expect a businessman would find himself convinced by that, and the question to him would be that he was going to put in a plant somewhere, and the question is Indonesia or California, and do you expect it would go to California?

A. No, I cannot imagine him making that mistake, regardless of the result of the outcome.

You would look to the fundamental economics of the reality of the situation, and I doubt strongly that he would be fooled into believing the California plant, because of the hypothetical formula that you have given me, was twice as profitable when, in fact, the reverse was true.

I suspect the businessmen that I know would tend to regard the Indonesia plant in this example as more profitable, and if the risks were such that twice as much profit was enough, you would tend to regard that as a better prospect for future business investments.

Mr. Willson: That is all the questions I have.

The Court: All right. I take it, Mr. Plant, you will have cross-examination?

Mr. Plant: Yes, your Honor.

The Court: And do you suggest we do that at 9:30 tomorrow morning?

Mr. Plant: Fine, your Honor.

The Court: Is that convenient to counsel and the witness?

Mr. Willson: It is a question whether it is convenient to our witness, your Honor. We prefer to do it now, obviously, unless Mr. Plant anticipates it will take some time.

The Witness: I would have to cancel my appointment tomorrow at Stanford.

The Court: My attaches have been going since 9:00, as you appreciate.

I don't mind missing a judge's meeting that I am supposed to attend at 4:30, that is fine, but I wonder how much Mr. Plant, if you have more than twenty minutes, which I anticipate you may?

Mr. Plant: Your Honor, what I want, most of all, was to have about ten minutes with Dr. Cerf to review and formulate a few questions on cross-examination. And that I believe will be the biggest cause of delay.

I was going to ask for a continuance if we go on.

The Court: Well I will try to accommodate the witness as much as I can.

And this is the only witness, except for perhaps the Franchise Tax Board—

Mr. Plant: We do not have a witness.

The Court: So with that in mind, I will be happy to accommodate the doctor insofar as I can, but if I see extensive cross-examination, I will have to put it over.

Mr. Willson: I am sure we can work it out to be here at 9:30.

The Court: What I am saying, if that is the only way, I will be glad to accommodate you.

I say if it is more convenient to have him here tomorrow afternoon, he can be here tomorrow afternoon. I don't know your schedule. And if you want to discuss it with counsel, you may.

All I can say, I have to do it tomorrow, because I will be unavailable next week. That is my only restriction.

Mr. Willson: If you could recess, Mr. Plant, do you think it will take a while?

(Whereupon, all counsel confer.)

Mr. Willson: We can make it at 9:30.

The Court: I appreciate that. It does not look like you will be occupied too much beyond that. I will make sure we accommodate you.

Thank you very much gentlemen, and you have the opportunity to prepare, and it might shorten things. See you at 9:30.

[Certificate Omitted in Printing]

FRIDAY, FEBRUARY 24, 1978 9:40 O'CLOCK A.M.

PROCEEDINGS

The Court: The case of Container Corporation of America versus Franchise Tax Board, No. 673492.

When we recessed yesterday evening, Professor McDonald was on the stand.

Dr. McDonald, will you resume the stand.

JOHN G. McDONALD,

called as a witness on behalf of the plaintiff, having been previously duly sworn, resumed the stand and testified further as follows:

The Court: Good morning, Doctor.

The Witness: Good morning.

The Court: We have Miss Tedeschi with us this morning, so, perhaps, it might be well if you state your names for the record.

Mr. Willson: Prentiss Willson.

Mr. Latcham: Franklin Latcham. We're for the plaintiff.

Mr. Plant: Philip Plant for defendant.

The Court: Fine.

Mr. Plant, I believe it's your opportunity for cross-examination.

Mr. Plant: Thank you, your Honor.

CROSS-EXAMINATION

By Mr. Plant:

Q. Dr. McDonald, yesterday you testified as to different factors that were considered by companies in determining hurdle rate. One distinction that you mentioned was the difference between whether a company is going to put on the market a new product as opposed to what you characterized to be a line extension.

Could you explain why a company would make a distinction in this regard?

A. For a given company, a new product to that company is usually regarded as having more risk than an extension of an existing product line, because of their past experience.

That is to say, a new product involves new learning, it involves production, marketing the whole stream of business which is involved with the process following the investment itself. The lack of experience to that particular company simply carries with it an element of risk broadly defined; whereas, an extension of an existing business

implies substantial previous experience, and so, the perceived risk to the company in something that they know how to do is regarded as being less.

Q. Well, then, would it be fair to say that the hurdle rates may be dependent upon other risk factors independent of the situs of the proposed investment in a foreign country?

That is to say, you've enumerated certain risk factors associated with business know-how, production and marketing of a product. This type of risk factor, I imagine, would be a relevant consideration whether you're considering an investment in a foreign country or an investment domestically?

A. Yes. That's correct. The site of the investment is one factor, and as I testified yesterday, for an existing business in an existing product line and a given company, the hurdle rate would be higher in a foreign country than it would be in the United States.

Certainly, the product itself and the kind of business area that they're investing in would be another factor, and that would obtain in domestic investments as well.

Q. Are there any risk factors you can think of other than the two we've touched upon; that is, the risk factor associated with the situs of the proposed investment in a foreign country or domestically being one consideration, the other being the consideration of whether or not the company is undertaking a new product line as opposed to expanding an existing line.

Is there any other risk factor which might affect a company's propensity to invest, that you can think of?

A. I think that many individual companies talk about it in a wide variety of language, and if you talk to ten companies, they will break it down in what appears to be ten different ways.

But on a little bit deeper examination, it seems to me it is the environment or the country location and the nature of the product itself from the company's point of view which is central. Often this is articulated in terms of the technology of the product, in terms of the channels of distribution of the product, language which sounds like marketing and production and so on, which may sound a little broader than simply line extension and new product.

And so, I take these to be the central categories, but there may be a matrix in this spectrum which is much more complicated in some countries than just line extension versus new product, and foreign versus domestic.

I meant really to raise that as an example of a four-part classification in one company that I mentioned yesterday.

Q. How complicated in your experience do these hurdle rates generally get? Does a company, for example, focus on a given country and then consider adjusting a hurdle rate, or do they have across-the-board hurdle rates that they apply to geographical areas?

You mentioned, for example, a situation where they had four hurdle rates: domestic, variable, existing product line

versus new product line, which in their interplay generated four different hurdle rates.

Does a company get into a more detailed consideration of the matter when they approach the process of seriously considering an investment in a given foreign country, or an investment in a new product line?

A. Here, again, it depends on the company and the industry. The process that I have observed in my own experience is really an evolutionary one. There are many companies that have divided the world into domestic and foreign, and having looked at it a little more closely and then moved away from that simple two-part classification in terms of geography to something more refined, perhaps, first of all, to break it down in terms of industrial European countries versus developing countries, then, perhaps, to break it down further within Latin America.

For example, to say that Peru appears to be risker today, for example, than Brazil might be, because of the relative size of the countries, and so on.

So, I think, perhaps, the best example I could give you of a very refined breakdown would be that used by many large commercial banks do business in many, many countries, and look at each one in terms of its current country risk, as they call it.

Q. Thank you.

Would you say there are situations in which a corporation might disregard its hurdle rate for special reasons? Maybe it would be helpful in conjunction with this question if I enumerated a few hypothetical possibilities.

Suppose there's an increased demand in a country where there's an increased demand for an existing line of products in a country where this company is already established and operating. It might consider the possibility of increasing the line of that product at less than hurdle rate for fear that were it to do otherwise it would permit the establishment of a competitor.

Suppose that a company is approached with an offer of a joint venture by another company whereby the risks attendant to such investment would be spread.

Suppose the size of a potential market in a foreign country is so great that it seems exceedingly attractive on that ground alone.

Suppose a country has surplus raw materials in one of its operations in a neighboring foreign country, and this would provide a convenient source should it commence operations next door.

And consider if you would the concept that a company might gain some prestige from being a quote, "multinational," unquote.

With factors such as this, do you think there are situations where a corporation might disregard its hurdle rate in a particular investment?

A. I think if you talk to corporate financial managers and ask them if they've ever made investments whose indicated returns were less than the hurdle rate, nearly all of them would say yes, and they would start with the corporate cafeteria, and they would start with smokestack invest-

ments required by law to clean up emissions into the air, and they would give examples like that of investments which would appear at first glance on the forms that are filled out in which ready return is calculated to have indicated expected rates of return which are less than hurdle rate.

In talking further with them, I think it's important to get beyond the language that they're using, which often says it's a necessity, or it's needed, or it makes good sense, or it has strategic importance, or it's for practical importance.

And I don't mean to address every one of the examples that you've raised, but rather to generally address the point that I think that it's very often difficult to quantify all of the benefits from an investment in concrete terms that go on that form in which rate of return is calculated.

And so, the indicative rate of return from time to time may appear to be lower on an expected basis than the hurdle rate, and costs will go ahead. But the fact of the matter is, I think, that in going a little bit deeper, the real expected rate of return implicit in the decision to go ahead is very often, in fact, greater than the hurdle rate which is indicated.

Let me give you a single example that I looked at recently of a company that went ahead with an investment that had an indicated rate of return of five percent when their hurdle rate was 15 percent.

But when you looked at the forms, you saw that they were just projecting cash flows over a two-year period into

the future, a very short time horizon, when, in fact, they really expected to operate that investment for ten or 20 years.

So, the calculation ignored the future cash flows in the sense that if you had taken those into account by making those very difficult expectational projections into the future, the rate of return on the form for a 20-year time horizon evaluation might well have been in excess of the hurdle rate

So, the question there is, was the investment meeting the hurdle rate, or wasn't it?

And in terms of the strict first draft of the forms, it appeared not to. But in terms of a more complete analysis and a longer time horizon the company happened to be using on that form, it appeared that it did.

So, the point of this little example is simply that management's common sense in this case was very much in accord with the thrust of the analysis which says you make investments if they are indicating an expecting rate of return that is in excess of the hurdle rate.

Q. But hypothetically speaking, wouldn't it be good business judgment in a situation whereby, establishing a business operation in a neighboring country, you create a market for raw products of an existing company you have next door, to make the investment in that foreign country at less than the hurdle rate with the expectancy that you are going to increase the return in the adjacent country in your existing business, for example?

A. Well, I'm not sure that I follow your hypothetical example. I might give you one in my own experience, and perhaps, you could tell me if this is to the point that you're raising.

When a large company in the mining business in South Africa decides to go into the mining business in Zambia to the north, they, in the past, evaluated that as a stand-alone investment.

It may have increased their presence in the continent, and there may have been some overhead personnel that would look after both divisions at a very high level, but they made an attempt to allocate the Board of Directors' time, the President's time, to both of these divisions in such a way that the companies truly reflected what an economist and an accountant and good common sense businessman would have thought was a reasonable allocation.

It's done every day. And given those numbers, the rate of return is calculated on the prospective proposed Zambian operation as a stand-alone investment. That is to say, I think it would not have been improved if the investment looked undesirable, simply on vaguer grounds that it might have helped the existing investment in South Africa.

The pencil is sharpened, I think, on investments like this, and each one has to bear its own weight.

Q. But, again, let me try another hypothetical.

You have a country. You have an existing business operation in Country A, and you're considering the possibility of establishing an operation in adjacent Country B.

You have awareness that their competitor's considering establishing an operation in the adjacent country, and you fear that should the competitors get a foothold, it might ultimately end up affecting your existing sales of that line of products in Country A.

Would not that be a factor that you would consider in deciding at what level you would set your hurdle rate?

A. To be sure that I understand, are you suggesting that the Country B new operation would be shipping products physically across the frontier into Country A?

Q. Yes.

A. I think in that case companies that I—for example, let's take Country A being the United States, and Country B to be Canada, where there is substantial shipping in that instance across the border from Canada to the United States.

There would be an attempt in evaluating the proposed investment in Canada to take into account all of the benefits and costs which are associated with that investment.

The benefits and costs are defined normally in business terms as the cash flow to the company with that investment, as opposed to the cash flow to the company without that investment.

So, the incremental benefits and costs of the corporation or in a proposed Canadian investment, all things considered, would be allocated as best they possibly could to that proposed investment, and there would be an attempt made to calculate a rate of return on the incremental investment.

Q. So, is that the same as saying that if you are convinced that the establishment of the Canadian operation will increase the cash flow of the existing United States operation, you would attribute that increase in the cash flow to the United States operation to the Canadian operation in computing their rate of return?

A. I'm trying to be responsive to this notion of shipping a physical product across the frontier, so that I take it what you're saying, it would replace in some sense the production of the American plant, because normally, my experience is companies try to evaluate each investment as much as possible on a stand-alone basis, but there's some attempt made to allocate those overhead costs, and so on, which are common to the whole company.

And I use just as a simple example the President of the company and those people who have to look over all divisions combined, but the first inclination is to try to see whether this thing makes sense standing on its own.

And I have not found in my experience in the real world of business that people make an enormous effort to try to calculate the impact on all other parts of the business of a given investment in a new country.

Normally, it's regarded as much as possible as a separate entity, as a stand-alone new division in the country of Canada.

Q. But you do say "as much as possible," meaning that you do consider the inner relationship of the new operation with the overall business?

A. If it were so dramatic as you described as to replace production in Country A, for example, then you'd have to look at the increment cost of business, the new way of operation as opposed to the old way of operating.

Q. You mentioned previously, I think, the short-run and certain investments made that might not bear an acceptable return for a transitory period of time, but the long-range expectancy would be that they would.

What, generally, are the time constraints associated with this hurdle rate concept? What length of investments do you usually consider, and how long do you usually consider acceptable before a company, say that was starting a new endeavor in a foreign country and a new product line, how long would you allow before the profit made by that operation would reach the acceptable minimum hurdle rate, generally?

I realize it's a tough question.

A. Yes. It's very difficult to generalize very different kinds of business. I understand your question to be that given an indicated investment has an overall rate of return which is in excess of the hurdle rate, how long would it have to be before the year-to-year results come up to that long-term level.

If you take an example, just to be concrete, of an American bank opening up a new branch in Sao Paulo, Brazil, for example, it may be several years before that particular branch is profitable on a year-to-year basis, but the expectation is that as you look at ten years or 20 years, the

overall rate of return on that investment will exceed the bank's hurdle rate for doing business in Brazil.

Now, the patience level of the company, in looking at the time horizon for the year-to-year returns to come up to a positive cash flow, just varies enormously from business to business, and it's very difficult to generalize.

There are some companies that are willing to wait five or six years; some will be wait longer. But, generally, these time horizons are rather shorter than that.

That is to say, it may take a year or two to get it up and running, and then it's expected that the operation will stand on its own and be profitable.

But I don't mean to imply that that time pattern will be the same for a Coca-Cola operation in Mexico as it would be for a bank branch in Brazil, or a copper mine in Peru. I think it just varies greatly across different kinds of business.

Q. A couple of questions on the rates of return that you referred to yesterday.

You indicated there are various items that are included in the numerator or denominator of the profit capital investment aspects of the rate of return, that they do differ from one company to another.

What type of variable are there? How can you change capital investment, for example?

A. Let me just give you a few examples.

The two most common varieties of calculation of profit in the numerator simply is pre-tax versus after-tax profit.

And, I would say, in my experience, comparably, the two widest varieties of ways to calculate the denominator, that is, the investment base, would be long-term investment capital usually taken to be total equity investment, plus long-term debt, on the one hand, and assets, on the other hand.

That is to say, the total assets or the net assets in the plant.

Now, most companies make a big effort to use whatever variety of this ratio they come up with consistently throughout the divisions of the company, and they try to define a hurdle rate which is consistent with that definition.

But there are just very many variations on the theme in terms of exact accounting definition of each of those items in the ratio which is profitability.

Q. Isn't it true that the actual profit figure, be it before or after taxes, that a corporation will come up with is dependent upon the particular sets of accounting procedures that it pursues in such areas, for example, as choice of depreciation methods, depreciation lives, inventory methods, allocation of joint costs, methods of accounting for transfers to and from related companies?

A. Yes, it does.

Q. While as you said most companies doubtless use the same sets of accounting procedures and the same general rate of return formula, would it not, without detailed analysis, be difficult to compare one company's rate of return against another company's rate of return?

A. It is important in making comparisons to make the measures on the two sides of the comparison as comparable as is practically possible.

Q. What influence, if any, would a change in the exchange rate of a foreign country currency as opposed to American currency have in the rate of return of, say, a manufacturing plant which an American company has established in this foreign country? Wouldn't that change the rate of return?

A. Are you talking about the expected rate of return, or the actual rate of return?

Q. The actual rate.

A. Now, on a year-to-year basis, focusing on a short run, if our profits in a foreign subsidiary are transferred quarter by quarter or year by year into dollars, then, the short-run fluctuations in the exchange rate do affect the actual rate of return in dollars.

If you take a look at somewhat longer run, for example, the total discounted cash flow rate of return, which might be 20 years in terms of a foreign corporation, then, the short-run fluctuations in the exchange rate are much less important.

Q. Is that based on the assumption that these exchange rate fluctuations tend to level out?

For example, what if a foreign country had a continually decreasing exchange rate of the long-term?

A. No. It does not depend on that. The averaging out is a sufficient condition.

For example, in the case of France, where it seems to fluctuate back and forth, the French franc, vis-a-vis the dollar; but it's by no means a necessary condition.

For example, comparing the Brazilian cruzeiro against the American dollar, that exchange rate has changed in one direction rather than fluctuating back and forth.

The Court: I think the court reporter would like the spelling of cruzeiro.

The Witness: C-r-u-z-i-e-r-o.

Mr. Latham: -z-e-i-r-o.

The Witness: -e-i-r-o.

The reason is—it may appear puzzling at first, but the reason is that the change in the exchange rate affects the real flows in the country. That is to say, changes in the exchange rate, as for example between Brazil and the United States, would seem mostly or always to be in the same direction, reflect the long-range phenomenon that the internal rate of inflation is now and has been higher in Brazil than it is in the United States.

And, so long as that relationship, higher inflation in Brazil than in the United States, continues, then, there will be an erosion in the value of the Brazil currency vis-a-vis the American dollar.

However, that doesn't imply that there is necessarily an erosion in the rate of return that is earned in Brazil, because this higher rate of inflation in Brazil is reflected

in local interest rates, and it's reflected in local nominal rates of return that people earn in that country's currency.

For example, while a rate of inflation of 40 percent a year sounds simply astonishing because it is so high, the fact remains that there are interest rates in that country which are 25 or 35 percent in some cases, and people make nominal rates of return.

And by nominal, I mean denominated in the local currency of 40 or 50 or 60 percent. So, while there is an erosion in the exchange ratio in the value of the local currency, vis-a-vis the dollar, I need not imply that over the period of 20 years, the long-term investment, that the rate of return in dollars is necessarily affected.

Now, the rate of inflation reflects the risk, as well as the return side of the equation. But the point I'm making here is simply that both cases, such as France, where there's a vibrating exchange ratio around some mean value, and in cases such as Brazil where there is generally a one-sided continuing change in the exchange ratio—in both of these cases, the expected rates of return on foreign operations of American companies may be realized.

Q. I have trouble, but suppose you have a country and their exchange rate is continually increasing so that if you were to convert their yearly profits into dollars, for the parent company to state a rate of return in an annual report, you would always find that the dollars, because of the increased exchange rate, would be more.

How can this change?

A. May I take a specific example in illustration of the point you're making?

Q. Surely.

A. Let's take Germany, for example. The German mark has been appreciating against the dollar as you've described in your hypothetical just a moment ago

Now, if you take a short-run point of view, the company is in that business to make a very short-run profit, that is, from year to year, and then get out.

And I might add, that's not commonly the case for companies that make the kinds of investments we've been discussing. But if you take a short-run, year-to-year point of view and translate those foreign incomes into dollars, and assume—and this might not be a realistic assumption—but assume that they could be repatriated to the parent country on a year-to-year basis, then this appreciation in that German mark would increase the return from that country.

But, as you go out a little bit longer, the point is that that change in the exchange rate tends to affect the real economic situation from Germany vis-a-vis the United States. That is, it makes the somewhat cheaper dollar as opposed to the German mark, will help American products being exported, and will tend to hurt over time German products as the price of the Mercedes gets higher and higher, compared to a comparable American car.

And the real impact on the economy, as you trace through a number of future years, tends to be adverse.

That is, the purpose of exchange rate fluctuations over time in international business and economics is to level out these differences, that to affect the balance of trade and the rate of return that companies make in that.

So, in the short run, it would be highly favorable to an American-owned operation in Germany, but as the investment took hold, it would tend to be adverse. This is a process of equilibration in the international market.

So, the point of this is it would be incorrect with the long-run point of view to assume that this change in the value of the mark vis-a-vis the dollar necessarily meant enormous long-term windfall gain, or conversely, in a case of a country whose currency was weakening like Brazil, that the long-run return is necessarily less.

Q. When you speak of this adjustment, you mean the adjustment in import-export of goods between two countries in question? Is that what you mean?

A. Not only between the two countries in question, but from each of those countries to all the other countries in the world.

Q. What you're saying is when it reaches a point where you're not selling Mercedes, that there's going to be an adjustment in the world market which will cause the exchange rate to ultimately change back to become less inflationary?

A. It's not quite so simple or straightforward as that, but what I'm saying, in business terms, it will be more and more difficult to sell Mercedes in export markets, and

that what we take to be the international macro adjustment process on imports and exports will have a very real business impact on those individual companies.

And what was taken to be very good news in the short-run may be taken to be bad news in terms of sales and profits as the adjustment takes place.

Q. Now, this adjustment in the world market is—you speak of short-run and long-run, but it would seem to me that the adjustment you speak of might take a great many years.

A. Well, just how long the long-run is varies from situation to situation and country to country. But in an environment where exchange rates are able to change this adjustment process that I call the long-run may be beyond one or two years; maybe three, four, five years, or ten years in working itself out.

It's by no means over the generations. That is, these things, economics does work itself out, in the long run, is by no means out of businessmen's planning horizon.

But on the other hand, I don't mean to imply that these adjustments take place within a few quarters. It's a gradual process. It takes time.

Q. You mentioned yesterday there's a considerable variety of hurdle rates between different companies that you had experience with. I appreciate your earlier testimony that these are considered to be private information, but I do believe that you mentioned that you were of the impression that there's a fairly substantial variety of hurdle rates.

How do you explain the variety? How do you explain, in general terms, certain companies may have different hurdle rates?

A. In my experience, the overriding explanation has to do with the business risk that the company's basic line of enterprise entails; a food company versus a steel company, or an automobile company versus a copper company.

It depends on the business and industry, above all, in which the company finds itself, and depending on the nuance of the calculation, it may also depend on the financial risk of the company; that is, the capital structure of the company within that industry, and capital structures do vary within a specific industry, like the chemical industry, for example.

Those are the two major categories of difference.

Q. To take the concept of risk factor in a foreign country and to convert that into a mathematical expression of a greater expected return seems to me attempting to take something subjective and extrapolate it into a very objective quantity.

Could the fact that the risk factor is a subjective concept attribute—explain any differences?

A. I think not. I think that the central idea here is that all of the relevant risks in a new investment proposal, for example, exist in the present and in the future.

So, by definition, some people would call those subjective in the sense that nobody knows exactly what the future holds. That's the essence of risk itself.

But the fact remains that people do it every day. This is part of everyday business. And people within a single industry, while they may vary from person to person and company to company, do come to form a consensus about the risk, and I take that to be some degree of objectivity when informed and experienced individuals in a single industry agree to some extent. There does come to be formed a consensus about just how risky Peru is, and that is translated not by an equation or mathematical principle, but rather, by everyday business judgment into a number which has to do with the hurdle rate, that is, the minimum required rate of return.

And as the situation changes in a country like Peru, maybe revised upward from 30 to 35 percent, and that's based on, once again, the informed, economic, political, common-sense business judgment of the individuals who are responsible for those companies.

Q. You indicate there's a common recognition of acceptable hurdle rates, and yet, you testified that the companies regard their own individual hurdle rates as private stock.

How do you explain that?

A. I think it's explained by the reality of the fact that there are, as I talked to companies in a given industry, for example, similarities in the expected rate of return, the minimum hurdle rate required for new investment in the petro-chemical business, for example.

They are in the same ball park, but that need not imply that people in that industry that talk to each other and share

that information—it may appear to an outsider that being in the same ball park that it wouldn't make any difference. But still, it is taken to be proprietary private information by the people in that company.

They want to reserve the right to adjust it upward and downward without explaining to the public about that. It is not a deep, dark secret, but it's regarded as being a part of corporate policy.

So, I think it's absolutely consistent to have some uniformity within a spectrum for a given line of business in a given industry, and at the same time, have companies feel that this aspect of corporate policy, as so many others, is their private business.

Q. I think we're not offering cross purposes here. What I'm trying to get and acknowledge is that it is difficult to take the subjective subject of a risk and quantify it into an exact percentage that companies operating individually to determine hurdle rates when looking at the question of whether an accepted hurdle rate in a given country is 18 or 19 percent have a kind of conceptual problem, and the fact that they're in the same ball park with another company, by independent evaluation, they've come up within a percentage or two, nevertheless, there is that fact that there probably is a slight variation in the percentages just due to the subjective character of the evaluation of risk.

A. I think the essential point here with which I would agree is that companies looking at investments independently in Peru would agree that the hurdle rate there is higher than it is in the United States.

But as to the exact figure, whether it's 31 or 32 in Peru and 15 or 16 in California, there may obviously be differences in percentage points in their numbers, but the relationship between the two in that spectrum of hurdle rates is consistent within the industry.

Q. Thank you.

The testimony you gave yesterday regarding your opinion that riskier investments would bring higher actual rates of return, you referred to a study of sales of stock, I believe, in the United States, or sales of equities.

Do you have the author or the title or the cite for that article? I don't think you mentioned it.

A. Yes. The study was done by Professor William F. Sharpe, S-h-a-r-p-e, and it was published in the Financial Analyst Journal several years ago. I don't remember the exact date.

Q. Several years ago?

A. Yes.

Q. About '72, '73, '74, something of that sort? I'm just trying to get a general—

A. Yes. I think it may have been around 1975.

Q. Now, in speaking in terms of the fact that a riskier investment would, in your opinion, generate a higher actual rate of return, you are speaking in terms of averages?

A. Yes. The actual rate of return is an average. I did say that.

Q. By that, you mean that there is no assurance that any company who undertakes a riskier investment might in any individual instance secure a greater return?

A. No. If it were true that it were assured to be a higher return, then, it would be hard to attribute greater risk to it.

Q. It's also, I think you noted, true that while generally a given rate of return would on the average be higher under your theory of things, that in a given year it would be subject to fluctuation.

That is to say, that an investment which is a risky investment and which ultimately would generate a higher rate of return, it's hard to say in any given year what it's going to generate by way of return.

I think you mentioned, to use a classic symptom of a risky foreign investment, that it doesn't fluctuate, even though on the average, as you pointed out, in your opinion, it does generate a higher rate of return.

A. I think we saw an example of the year-to-year fluctuations in Schedule 7 that we talked about yesterday, in which the annual rates of return in most of the foreign operations fluctuated more, had more year-to-year variation than did the domestic return.

Mr. Plant: Your Honor, I have no further questions of Dr. McDonald.

The Court: Thank you very much.

Mr. Willson?

Mr. Willson: No. I have no questions, your Honor.

Mr. Latcham: No questions, your Honor.

The Court: You may step down. Thank you very much, Dr. McDonald. I think you're free to leave. Check with your attorneys.

Mr. Willson: Your Honor, I think we have two points we want to agree on before this is over, and we've talked about them.

One of them, one of the exhibits to the stipulation of facts, is the annual reports which are not in there for the truth of the matter submitted, but just simply there.

And there's an item, namely, the financial information attached to the annual reports which Mr. Plant has asked us if we would stipulate to the truth of that information. We'd like to get back and talk to the company.

So, we would like to reserve that question and leave it open, and at some point we'll come in, probably with a written addendum to the stipulation which reflects our agreement on this.

The Court: Perhaps you can file it when you file the briefs, whether or not it's stipulated to.

The first set of briefs, that is, relating to objections—

Mr. Willson: It will just take a couple days.

Mr. Plant: We would reserve the right in the event the plaintiffs felt they could not stipulate to this being admitted for the truth of the matter stated, to then, in

effect, make a motion that it be accepted for the truth of the matter stated as a party's admission.

But we're not making the motion now, with the understanding that they may be willing to just stipulate without that, if that's agreeable.

The Court: That's fine.

Mr. Willson: And the second point is on the briefing schedule itself, for the briefs, we agreed yesterday 10, 10 and 5, and then, 60, 60 and 30.

And the question thence, from when does the 60 begin to run? Mr. Plant and I are in agreement we'd like to have that period begin when we have your decision on the admissibility of the stipulation re testimony, if that's acceptable to you.

The Court: All right. The time on the 10, 10 and 5 will begin to run today upon the submission of the matter, and then, it will be ordered that from the date of the—whether it be an order or proposed order of the Court—in other words, I'm not sure what your briefs will show.

So, if it's extremely intricate, I may enter a proposed order and direct a party to enter the final order on the issue.

But from the time of the issuance of that, then the time would run on the other. That's when you'll have notice of my intended order, and you can begin then to prepare.

Now, the order will be then the submission on the merits will be on a schedule of 60, 60, 30—60 days for brief, plain-

tiff; 60 days response by Franchise Tax Board; 30 days rebuttal—will run the day of the order or proposed order of the Court re stipulation re testimony.

Mr. Plant: Thank you, your Honor.

The Court: Any other matters?

Mr. Plant: I have none.

Mr. Willson: No.

The Court: As I understand it, that which was introduced yesterday jointly Exhibit 1-A, which is a copy, and I can scribble in the margin and so on?

Mr. Willson: As a matter of fact, I think it might be helpful if I give you, also, a copy of the stipulation re testimony, and you could scribble in that as well.

Mr. Plant: No objection to that.

Mr. Willson: 2-A, or whatever. I'll leave you one.

The Court: Thank you.

Then, the issue is submitted?

Mr. Plant: Yes, your Honor.

The Court: Subject to all these contingencies.

Mr. Willson: Thank you, your Honor.

The Court: Submitted, Mr. Willson?

Mr. Willson: Yes. Submitted.

(Whereupon, the proceedings were concluded.)

[Certificate Omitted in Printing]

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FILED
JUL 19 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

vs.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

JOINT APPENDIX: EXHIBITS

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APPEAL DOCKETED SEPTEMBER 14, 1981
PROBABLE JURISDICTION NOTED MAY 3, 1982

BOWNE-PERNAU WALSH • 190 NINTH ST. • S.F., CA 94103 • (415) 864-2300

TABLE OF CONTENTS

	Page
Exhibit A to Stipulation of Facts	1
Exhibit F to Stipulation of Facts	9
Exhibit L to Stipulation of Facts	34

EXHIBIT A-1

1963 DATA

CCA's Foreign Subsidiaries	Net Profits	Sales	Avg. Property	Payroll
Cellulose y Papel de Colombia, S.A.	(72,888)	303,720	1,619,786	137,650
Carton de Colombia, S.A.	5,069,017	20,212,043	14,930,467	1,076,618
Cartoenvases de Mexico, S.A.	28,581	4,434,682	2,153,965	884,787
Carton y Papel de Mexico, S.A.	797,030	8,393,692	5,729,287	966,741
Industrias Aztlan, S.A.	—	—	—	—
Corrugadora de Carton, S.A.	392,818	3,118,810	1,539,486	501,868
Carton de Venezuela, S.A.	1,332,642	4,005,300	3,274,501	859,278
Union Grafica, S.A.	97,853	2,210,069	1,335,779	612,659
Cartones Nacionales, S.A.	344,486	3,733,404	5,684,949	507,776
Fibras Industriales de Venezuela, S.A.	10,964	580,107	149,360	118,894
Carton Internacional, S.A.	1,411,833	—	—	—
Europa Carton Austria, A.G.	(36,815)	—	194,365	—
Bremer Papier und Wellpappen Fabrik	492,219	4,098,631	1,783,664	1,020,100
Europa Carton, A.G.	701,473	20,653,910	12,903,051	4,849,900
N.V. Mercurius Golfkartonindustrie	322,731	2,705,294	541,436	323,891
Cartiera Europa Carton, S.p.A.	(288,621)	794,039	1,395,679	—
VOSA, S.p.A.	35,029	5,161,624	4,078,551	756,045
Europa Carton Italiana, S.p.A.	8,383	—	3,938	—
Cartotecnica Europa Carton	149,035	3,733,258	1,498,011	580,878
Total	10,795,770	84,138,583	58,816,275	12,894,985

EXHIBIT A-2

	1963 DATA			
	Net Profits	Sales	Avg. Property	Payroll
CCA	25,361,936	277,113,516	117,107,148	89,521,641
Less Interco. Sales				
CCA to:				
Carton de Colombia		(207,195)		
VOSA		(17,057)		
Bremer		(18,853)		
Europa Carton, A.G.		(208,594)		
Mercurius		(146)		
Cartotecnica		(3,170)		
Carton y Papel		(99,920)		
Carton de Venezuela		(65,487)		
Cartones Nacionales		(53,030)		
		(673,452)		
Combined CCA Sales		276,440,064		
CCA California factors		27,616,582	15,439,888	9,863,198

EXHIBIT A-3

1964 DATA

CCA's Foreign Subsidiaries	Net Profits	Sales	Avg. Property	Payroll
Cellulose y Papel de Colombia, S.A.	(3,825)	1,354,815	2,274,917	161,793
Carton de Colombia, S.A.	4,766,821	21,867,912	17,287,187	1,235,300
Cartoenvases de Mexico, S.A.	197,560	3,579,855	1,732,206	694,491
Carton y Papel de Mexico, S.A.	1,511,288	11,009,695	6,738,439	1,371,853
Industrias Aztlan, S.A.	—	—	—	—
Corrugadora de Carton, S.A.	609,577	4,499,441	1,567,651	684,808
Carton de Venezuela, S.A.	2,205,488	5,627,223	3,313,127	1,014,599
Union Grafica, S.A.	302,707	2,936,026	1,415,441	639,061
Cartones Nacionales, S.A.	2,028,311	5,591,098	5,689,752	639,967
Fibras Industriales de Venezuela, S.A.	15,104	743,274	125,978	132,716
Carton Internacional, S.A.	772,859	—	—	—
Europa Carton Austria, A.G.	(58,093)	—	156,590	—
Bremer Papier und Wellpappen Fabrik	515,188	4,265,270	1,961,610	1,073,575
Europa Carton, A.G.	879,184	23,991,662	13,603,414	5,131,200
N.V. Mercurius Golfkartonindustrie	397,121	3,191,337	604,273	375,084
Cartiera Europa Carton, S.p.A.	(52,643)	113,387	1,287,971	—
VOSA, S.p.A.	(127,121)	5,505,767	4,042,644	880,212
Europa Carton Italiana, S.p.A.	437	—	3,272	—
Cartotecnica Europa Carton	120,067	3,587,975	1,630,355	612,713
Total	14,080,030	97,864,737	63,434,827	14,301,412

EXHIBIT A-4

	1964 DATA			
	Net Profits	Sales	Avg. Property	Payroll
CCA	28,975,400	298,099,456	133,559,332	93,974,988
Less Interco. Sales				
CCA to:				
Carton de Colombia		—		
VOSA		(68,328)		
Bremer		(15,534)		
Europa Carton, A.G.		(594,487)		
Mercurius		—		
Cartotecnica		(109,859)		
Carton y Papel		(83,686)		
Carton de Venezuela		(154,303)		
Cartones Nacionales		—		
		(1,026,197)		
Combined CCA Sales		297,073,259		
CCA California factors		30,337,848	14,916,318	10,488,552

EXHIBIT A-5

1965 DATA

CCA's Foreign Subsidiaries	Net Profits	Sales	Avg. Property	Payroll
Cellulose y Papel de Colombia, S.A.	663,650	2,417,265	2,245,545	91,006
Carton de Colombia, S.A.	2,337,461	16,708,422	18,209,579	759,962
Cartoenvases de Mexico, S.A.	152,029	3,773,789	1,913,909	704,788
Carton y Papel de Mexico, S.A.	2,129,038	13,013,767	7,231,135	1,611,040
Industrias Aztlan, S.A.	366	1,439,198	846,225	275,704
Corrugadora de Carton, S.A.	746,938	5,422,651	1,642,725	765,044
Carton de Venezuela, S.A.	2,599,437	6,888,808	3,244,409	1,181,927
Union Grafica, S.A.	422,292	3,475,356	1,438,427	676,420
Cartones Nacionales, S.A.	1,628,677	5,837,890	6,300,553	683,168
Fibras Industriales de Venezuela, S.A.	614	842,896	107,791	159,475
Carton Internacional, S.A.	1,673,170	—	—	—
Europa Carton Austria, A.G.	56,331	—	90,011	—
Bremer Papier und Wellpappen Fabrik	549,261	4,831,323	2,273,290	1,199,775
Europa Carton, A.G.	2,241,355	28,290,398	13,736,540	5,700,750
N.V. Mercurius Golfkartonindustrie	431,444	3,245,627	682,717	402,297
Cartiera Europa Carton, S.p.A.	—	—	589,230	—
VOSA, S.p.A.	175,471	5,403,731	3,988,585	897,722
Europa Carton Italiana, S.p.A.	(2,336)	—	1,499	—
Cartontecnica Europa Carton	83,995	3,812,533	1,660,005	665,108
Total	15,889,193	105,403,654	66,202,195	15,774,186

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EXHIBIT A-6

	1965 DATA			
	Net Profits	Sales	Avg. Property	Payroll
CCA	30,026,749	322,557,262	158,266,349	97,673,507
Less Interco. Sales				
CCA to:				
Carton de Colombia		—		
VOSA		(101,143)		
Bremer		(30,851)		
Europa Carton, A.G.		(733,844)		
Cartotecnica		(157,911)		
Carton y Papel		(109,750)		
Carton de Venezuela		(168,917)		
Cartones Nacionales		(137,035)		
		(1,439,451)		
Combined CCA Sales		321,117,811		
CCA California factors		29,072,416	14,862,163	10,784,370

EXHIBIT A-7

CONTAINER CORPORATION OF AMERICA	1963	1964	1965
Income per U.S. Return			
Federal Taxable Income per Form 1120 (Line 28)	$26,692,247.93	$30,225,312.36	$35,994,917.38
Plus: Net Audit Adjustments	1,612,242.71	1,897,134.89	1,554,643.30
Less: Foreign Source Income Included in Line 28 (Per Form 1118)	(1,046,441.76)	(3,137,279.48)	(5,540,379.83)
Plus: Adjustments to FSI per Audit	91,158.00	1,508,379.00	486,316.00
CCA's Net U.S. Source Taxable Income	$27,349,206.88	$30,493,546.77	$32,495,496.85
Income per California Return			
California Return as Filed			
Federal Line 28	$26,692,247.93	$30,225,312.36	$35,994,917.38
Plus: State Taxes Based on Income	640,642.21	719,727.90	975,251.97
Interest on Government Obligations	45,722.92	40,366.27	186,735.01
Less: Foreign Dividend 'Gross Up'	(299,525.78)	(549,700.00)	(640,758.00)
Foreign Taxes Withheld at Source	(63,212.40)	(166,377.06)	(161,158.72)
Subpart F Income (Controlled Foreign Corps)	—	(1,412,315.00)	(3,779,550.00)
Additional Depreciation	(145,098.61)	191,758.43	—
Net Income After State Adjustments Federal	$26,870,776.27	$29,048,772.90	$32,575,437.64
Less: Dividends not Deducted From Line 35	(645,926.34)	(877,772.57)	(811,181.47)
Non-business Interest	(1,023,283.00)	(925,431.92)	(960,729.05)
Gain on Sale of Non-Unitary Assets	(349.27)	(274,452.42)	(294,594.74)
Plus: Interest Offset	1,669,209.34	1,803,204.49	1,771,910.52
Unitary Business Income per Return	$26,870,427.00	$28,774,320.48	$32,280,842.90
Modifications per Audit			
CCA Business Income as Reported	26,870,427.00	28,774,320.00	32,280,843.00
Plus: Subsidiary Income			
Domestic			(59,191.00)
Overseas	10,795,770.00	14,080,030.00	15,889,193.00
Gains and Losses		764,366.00	324,628.00
Bad Debts		1,127,162.00	
Interest Offset (Additional)	1,190,477.00	1,190,449.00	1,028,215.00
Less: Dividends from 2nd to 1st Tier Subs	(1,508,491.00)	(1,190,448.00)	(2,578,722.00)
	$37,348,183.00	$44,245,879.00	$46,884,966.00
Plus: Federal RAR Adjustments (per above)	1,612,243.00	1,897,135.00	1,554,643.00
Adjusted Unitary Business Income	$38,960,426.00	$46,143,014.00	$48,439,609.00

EXHIBIT A-8

FLOW OF GOODS FROM CCA TO FOREIGN SUBSIDIARIES

Subsidiaries' Purchase of Stock in Trade from CCA and Percentage of Subsidiaries' Total Cost of Goods Sold

	1963		1964		1965	
	$ Purchases	% COGS	$ Purchases	% COGS	$ Purchases	% COGS
Carton de Colombia	207,195	1.47%	—	—	—	—
VOSA	17,057	0.38%	68,328	1.40%	101,143	2.22%
Brener Papier and Wellpappen Fabrik	18,853	0.56%	15,534	0.04%	30,851	0.78%
Europa Carton, A. G.	208,594	1.12%	594,487	2.74%	733,844	3.03%
N.V. Mercurius Golfkartonindustrie	146	0.01%	—	—	—	—
Cartotechnica Europa Carton	3,170	0.01%	109,859	3.46%	157,911	4.64%
Carton y Papel de Mexico, S.A.	99,910	1.42%	83,686	1.00%	109,750	1.10%
Carton de Venezuela	65,487	2.85%	154,303	5.15%	168,917	4.47%
Cartones Nationales	53,030	1.89%	—	—	137,035	3.85%

Purchase by Subsidiaries of Depreciable Assets From CCA

	1963	1964	1965
Carton de Colombia	(Not Available)	42,268	1,842
Cellulosa y Papel de Colombia	—	500	0
Carton y Papel de Mexico	—	20,507	0
Carton de Venezuela	—	135	0
Europa Carton, A.G.	—	0	480
Cartoenvases de Mexico	—	0	911
Union Grafica	—	0	10,000

EXHIBIT F

AGREEMENT

THIS TECHNICAL SERVICE AGREEMENT, entered into this 23rd day of October, 1963, by and between CONTAINER CORPORATION OF AMERICA, a Delaware corporation having offices at 38 South Dearborn Street, Chicago 3, Illinois, U.S.A. (hereinafter referred to as "CONTAINER") and BREMER PAPIER UND WELLPAPPEN FABRIK AKTIENGESELLSCHAFT, having a place of business at Lubbecke, Germany (hereinafter referred to as "BREMER PAPIER")

RECITALS

I. CONTAINER is engaged in the manufacture and sale of paperboard products including containerboard and corrugated shipping containers, and consequently, because it has been operating in these industries for a long period of time, has accumulated much valuable experience to furnish technical assistance to corporations engaged in equal or similar industrial activities.

II. BREMER PAPIER is engaged in the same industries as CONTAINER. In order to develop its business on the German market, BREMER PAPIER wishes to partake of the experiences accumulated by CONTAINER in the industries as referred to in Recital I hereof by requiring assistance of CONTAINER, for which assistance BREMER PAPIER is willing to pay pursuant to this Agreement.

CLAUSES

FIRST: CONTAINER binds itself to perform services and to provide advice and consultation to BREMER PAPIER concerning manufacturing techniques, engineer-

ing, design, architecture, insurance and cost accounting in accordance with CONTAINER's progress in these areas, and to render any other assistance which BREMER PAPIER may require in connection with any aspect of its industrial or commercial operations.

In order that BREMER PAPIER may receive in an efficient manner the advice and consultation referred to in the preceding paragraph, CONTAINER will furnish BREMER PAPIER with all technical bulletins and other material that CONTAINER uses in the United States and that BREMER PAPIER may require from time to time. CONTAINER will undertake to answer BREMER PAPIER's requests for assistance in these areas by correspondence as explicit as BREMER PAPIER may require, and besides, at the request of BREMER PAPIER it shall send qualified personnel to Germany or train employees of BREMER PAPIER.

SECOND: If technicians are sent from the United States, CONTAINER will pay for transportation expenses and BREMER PAPIER will be responsible for the cost of reasonable living expenses which may be involved in the visit of these employees in Germany. BREMER PAPIER will pay for all travelling and living expenses which occur when BREMER PAPIER employees are sent to the United States for training.

THIRD: BREMER PAPIER shall not have the right to pass the informations received from CONTAINER on to third parties, but only to use it for its own ends.

FOURTH: For the services rendered under this contract BREMER PAPIER shall pay CONTAINER a fee of thirty-five hundredths percent (0.35%) of BREMER PAPIER trade sales. Payment will be made at the end of each month and be based on BREMER PAPIER's trade sales of the preceding month. The first payment will be made on the trade sales of July, 1963.

FIFTH: This Agreement is made between CONTAINER and BREMER PAPIER for the period July 1, 1963 to June 30, 1964. It will continue in effect for each one year thereafter unless one party makes written notice three months prior to the end of any period.

SIXTH: This contract can be modified only by written agreement between the two parties.

SEVENTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves to the laws and courts of the City of Chicago, Illinois, United States of America, or those of the City of Lubbecke, Germany.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their appropriate officers.

Chicago, Illinois

CONTAINER
CORPORATION
OF AMERICA

ATTEST:

By Harry E. Green /s/
Senior Vice President

Joseph B. Higgs /s/
Assistant Secretary

Lubbecke, Germany

BREMER PAPIER UND
WELLPAPPEN FABRIK
AKTIENGESELL-
SCHAFT

By Gerhard Schmidt /s/
Chairman of the
Management Committee

WITNESS:

Wilhelm Holle /s/

TECHNICAL SERVICE AGREEMENT entered into by and between CONTAINER CORPORATION OF AMERICA, domiciled at 38 South Dearborn Street, Chicago 3, Illinois, U.S.A. (hereinafter referred to as "CONTAINER") and CARTOENVASES DE MEXICO, S. A., represented by its Vice President, James J. Minnis, domiciled at Lago Chapala 26-P, Colonia Anahuac, in Mexico, F. D. (hereinafter referred to as CARTOENVASES).

RECITALS

I. Container Corporation of America is a Delaware (U.S.) corporation and it engages in general industrial activities consisting of the production of paperboard and all kinds of paperboard packaging, as well as connected activities such as the purchase of machinery, the purchase of raw materials, the operation of industrial plants, etc., and consequently, it has within its industrial, administrative and commercial personnel the experts necessary to furnish technical assistance to corporations engaged in equal or similar industrial activities. By virtue of its commercial relationship with Cartoenvases, Container is willing to furnish it the necessary technical assistance pursuant to this Agreement.

II. Cartoenvases de México, S. A. is a Mexican corporation legally constituted under the laws of the Mexican Republic and is at present the owner of a folding carton plant and a fibre can plant in Mexico, D. F. and a corrugated shipping container plant in the District of Ecatepec de Morelos, State of Mexico. For the efficient operation of the above-mentioned industrial plants, Cartoenvases

requires the technical assistance which it has requested from Container as a consequence of their close commercial relationship, which assistance Cartoenvases is willing to receive and pay for pursuant to this Agreement.

CLAUSES

FIRST: Container binds itself to render Cartoenvases technical Assistance for the efficient operation of the industrial plants referred to in Recital II hereof, for the efficient production of folding cartons and fibre cans, as well as for any other similar activity that Cartoenvases may carry out in the future in Mexico. As a consequence of Container's obligation, Cartoenvases shall have the right to receive technical assistance as far as concerns the purchase of machinery and raw materials, the supervision of production methods and the improvement of same in accordance with Container's technical progress, the information of such raw material or finished products markets as may be of interest to it, as well as any other assistance which it may require in connection with any aspect of its industrial or commercial operations.

SECOND: In order that Cartoenvases may receive in an efficient manner the technical assistance referred to in the preceding Clause, Container hereby binds itself to furnish to Cartoenvases information, market quotations, sources of supply, industrial methods, all this by writing and as explicit as Cartoenvases may require, and besides, at the request of Cartoenvases it shall send to Mexico all the technicians or specialized personnel working under the services of Container which Cartoenvases may require from time to time.

THIRD: All the information that Cartoenvases receives from Container under this Technical Service Agreement shall be considered strictly confidential, and Cartoenvases shall not have the right to pass it on to third parties but only to use it for its own ends.

FOURTH: Cartoenvases shall pay Container the amount of $6,100.00 (U.S. Currency) on the first day of July 1963, and $2,700.00 per month on the first day of each month thereafter, for the technical services which it shall receive from Container. Payments shall be made by bank draft drawn on Chicago, Illinois. In addition to the above compensation, Cartoenvases binds itself to pay for its own account or to reimburse Container all the traveling expenses and living expenses involved in the visit of the technicians sent by Container to Cartoenvases' plants. Such expenses shall be paid or reimbursed by Cartoenvases as soon as they are incurred.

The reason for the reduction in payment, effective August 1st, 1963, is the sale of the corrugated shipping Container division as of that date.

FIFTH: The parties hereto may from time to time request the adjusting of the provisions of this Agreement, in accordance with what it may be practical once the technical assistance agreed upon herein is put into effect.

SIXTH: This Agreement has an indefinite duration; however, any of the parties hereto may terminate it by means of a written 180 day prior notice to the other. Such 180 days shall be calendar days.

SEVENTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves, at the election of the plaintiff, to the laws and courts of the City of Chicago, Illinois, United States of America, or those of the City of Mexico.

EIGHTH: This Agreement shall start taking effect on July 1, 1963.

CONTAINER CORPORATION
OF AMERICA

By: EDWARD K. MEIER
Secretary

Chicago, Ill.,

CARTOENVASES DE MEXICO, S.A.

By: JAMES S. MINNIS
James S. Minnis
Vice President

Mexico City

AGREEMENT entered by and between CONTAINER CORPORATION OF AMERICA and CARTON Y PAPEL DE MEXICO S.A.

RECITALS

I. Container Corporation of America and Carton y Papel de Mexico S.A. entered a Technical Assistance Agreement on July 1st, 1963, by virtue of which the first company was bound to supply the second technical assistance for the efficient operation of the industrial plants it owns and operates at Los Reyes, Tlalnepanta, State of Mexico and at Cerro Gordo, Ecatepec de Morelos, State of Mexico.

II. Since said contract was in effect, Container has given said services; but due to the increase in the operation of Carton y Papel de Mexico's plants which has become necessary to have larger technical assistance available, and Container has requested an increase of the compensation it receives and, therefore, the parties are in agreement of the following.

CLAUSES

FIRST. Contents of clause fourth of the agreement referred to in Recital I of this agreement so as in the future it is read in the following terms:

"Fourth: As compensation for the technical assistance received by Carton y Papel, said company shall pay to Container the amount of D.ls. $13,000 U.S. Cy. monthly, payable each month in American currency in a bank draft on Chicago, Ill. Besides the above compensation, Carton y Papel is obliged to pay by its own account, or to reimburse

Container for all the travel expenses caused by visits to said plants of Carton y Papel by technicians sent by Container. These expenses shall be paid or reimbursed by Carton y Papel as soon as they are incurred."

SECOND. Except for the agreement referred to in the above clause, the Technical Assistance Agreement that binds the parties since July 1, 1963, shall remain fully in effect in the parties subject to honor in the terms agreed upon.

THIRD. This agreement has the sole purpose of adjusting to the real facts the compensation due to Container and does not renew or amend in any other way the existing agreement.

July 1st, 1964

CONTAINER CORPORATION
OF AMERICA

By: _____
Chicago, Ill. U.S.A.

CARTON Y PAPEL
DE MEXICO S.A.

By: _____
Indalegio Celorio Ortega
Vice President.
Mexico, P.F.

TECHNICAL SERVICE AGREEMENT entered into by and between CONTAINER CORPORATION OF AMERICA, domiciled at 38 South Dearborn Street, Chicago 3, Ill., U.S.A. (hereinafter referred to as "CONTAINER") and CARTON Y PAPEL DE MEXICO. S.A., represented by its Vice President, Mr. Indalecio Celorio Ortega, domiciled at No. 463 Helaber Campo Ave., Office 102, in Mexico, P.D. (hereinafter referred to as "CARTON Y PAPEL").

RECITALS

I. Container Corporation of America is a Delaware (U.S.) corporation, and it engages in general industrial activities consisting of the production of paperboard and all kinds of paperboard packaging, as well as connected activities such as the purchase of machinery, the purchase of raw material, the operation of industrial plants, etc., and consequently, it has within its industrial, administrative and commercial personnel the experts necessary to furnish technical assistance to corporations engaged in equal or similar industrial activities. By virtue of its commercial relationship with Carton y Papel, Container is willing to furnish it the necessary technical assistance pursuant to this Agreement.

II. Carton y Papel de Mexico, S.A. is a Mexican corporation, legally constituted under the laws of the Mexican Republic and is at present the owner of a paper and cardboard plant which it operates at Los Reyes, Tlalnepantla, State of Mexico and a similar plant at Cerro Gordo, Ecatepec de Morelos, State of Mexico. For the efficient

operation of the above-mentioned industrial plants, Carton y Papel requires the technical assistance which it has requested from Container as a consequence of their close commercial relationship, which assistance Carton y Papel is willing to resolve and pay for pursuant to this Agreement.

CLAUSES

FIRST: Container binds itself to render Carton y Papel technical assistance for the efficient operation of the industrial plants referred to in Recital II hereof, for the efficient production of board and cardboard and corrugated shipping containers, as well as for any other similar activity that Carton y Papel may carry out in the future in Mexico. As a consequence of Container's obligation, Carton y Papel shall have the right to receive technical assistance as far as concerns the purchase of machinery and raw material, the supervision of production methods and the improvement of same in accordance with Container's technical progress, the information of such raw material or finished products markets as may be of interest to it, as well as any other assistance which it may require in connection with any aspect of its industrial or commercial operations.

SECOND: In order that Carton y Papel may receive in an efficient manner the technical assistance referred to in the preceding Clause, Container hereby binds itself to furnish to Carton y Papel information, market quotations, sources of supply, industrial methods, all of this by writing and as explicit as Carton y Papel may require, and besides, at the request of Carton y Papel it shall send to Mexico

all the technicians or specialized personnel working under the services of Container which Carton y Papel may require from time to time.

THIRD: All the information that Carton y Papel receives from Container under this Technical Service Agreement shall be considered strictly confidential, and Carton y Papel shall not have the right to pass it on to third parties but only to use it for its own ends.

FOURTH: Carton y Papel shall pay Container the amount of $18,800.00 (U.S. Currency) on the first day of July, 1963, and $39,000.00 per month on the first day of each month thereafter for the technical assistance which it shall receive from Container. Payments shall be made by bank draft drawn on Chicago, Illinois. In addition to the above compensation, Carton y Papel binds itself to pay for its own account or to reimburse Container all the traveling expenses and living expenses which may be involved in the visit of the technicians sent by Container to Carton y Papel's plants. Such expenses shall be paid or reimbursed by Carton y Papel as soon as they are incurred.

The reason for the increases in payment, effective August 1st, 1963, is the purchase of the corrugated shipping Container division as of that date.

FIFTH: The parties hereto may from time to time request the adjusting of the provisions of this Agreement, in accordance with what it may be practical once the technical assistance agreed upon herein is put into effect.

SIXTH: This agreement has an indefinite duration; however, any of the parties hereto may terminate it by

means of a written 180 day prior notice to the other. Such 180 days shall be calendar days.

SEVENTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves at the election of the plaintiff, to the laws and courts of the city of Chicago, Illinois, United States of America, or those of the City of Mexico.

EIGHTH: This agreement shall start taking effect on July 1st, 1963.

CONTAINER CORPORATION
OF AMERICA

By Edward K. Meier
Secretary
Chicago, Illinois

CARTON Y PAPEL
DE MEXICO, S.A.

By: I. Celorio O.
Indalegio Celorio Ortega
Vice President.
Mexico City

TECHNICAL SERVICE AGREEMENT entered into by and between CONTAINER CORPORATION OF AMERICA, domiciled at 38 South Dearborn Street, Chicago 3, Illinois, U.S.A. (hereinafter referred to as "CONTAINER") and INDUSTRIAS AZTLAN, S.A., represented by its Vice President, Alex Kaplan, domiciled at KM. 15½ Carretera Mexico-Laredo, Sta. Clara, Edo. de Mexico (hereinafter referred to as AZTLAN).

RECITALS

I. Container Corporation of America is a Delaware (U.S.) corporation and it engages in general Industrial activities consisting of the production of paperboard and all kinds of paperboard packaging, as well as connected activities such as the purchase of machinery, the purchase of raw materials, the operation of industrial plants, etc., and consequently, it has within its industrial, administrative and commercial personnel and experts necessary to furnish technical assistance to corporations engaged in equal or similar Industrial activities. By virtue of its commercial relationship with Aztlan, Container is willing to furnish it the necessary technical assistance pursuant to this Agreement.

II. Industries Aztlan, S. A. is a Mexican corporation legally constituted under the laws of the Mexican Republic and is at present the owner of a folding carton plant, located at the above mentioned address. For the efficient operation of the mentioned industrial plant, Aztlan requires the technical assistance which it has requested from

Container as a consequence of their close commercial relationship, which assistance Aztlan is willing to receive and pay for pursuant to this Agreement.

CLAUSES

FIRST: Container binds itself to render Aztlan technical assistance for the efficient operation of the industrial plant referred to in Recital II hereof, for the efficient production of folding cartons, as well as for any other similar activity that Aztlan may carry out in the future in Mexico. As a consequence of Container's obligation, Aztlan shall have the right to receive technical assistance as far as concerns the purchase of machinery and raw materials, the supervision of production methods and the improvement of same in accordance with Container's technical progress, the information of such raw material or finished products markets as may be of Interest to it, as well as any other assistance which it may require in connection with any aspect of its Industrial or commercial operations.

SECOND: In order that Aztlan may receive in an efficient manner the technical assistance referred to in the preceding Clause, Container hereby binds itself to furnish to Aztlan information, market quotations, sources of supply, industrial methods, all this by writing and as explicit as Aztlan may require, and besides, at the request of Aztlan it shall send to Mexico all the technicians or specialized personnel working under the services of Container which Aztlan may require from time to time.

THIRD: All the Information that Aztlan receives from Container under this Technical Service Agreement shall be considered strictly confidential, and Aztlan shall not have the right to pass it on to third parties but only to use it for its own ends.

FOURTH: Aztlan shall pay Container the amount of $3,000.00 (U.S. Currency) per month, for the technical service which it shall receive from Container. Payments shall be made by bank draft drawn on Chicago, Illinois. In addition to the above compensation, Aztlan binds itself to pay for its own account or to reimburse Container all the travelling expenses and living expenses involved in the visit of the technicians sent by Container to Aztlan's plant. Such expenses shall be paid or reimbursed by Aztlan as soon as they are Incurred.

FIFTH: The parties hereto may from time to time request the adjusting of the provisions of this Agreement, in accordance with what it may be practical once the technical assistance agreed upon herein is put into effect.

SIXTH: This Agreement has an indefinite duration; however, any of the parties hereto may terminate it by means of a written 180 day prior notice to the other. Such 180 days shall be calendar days.

SEVENTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves, at the election of the plaintiff, to the laws and courts of the City of Chicago, Illinois, United States of America, or those of the City of Mexico.

EIGHTH: This Agreement shall start taking effect on September 1, 1965.

CONTAINER CORPORATION
OF AMERICA

By: /s/ HARRY E. GREEN
Senior Vice President
Chicago, IL., U.S.A.

INDUSTRIAS AZTLAN, S.A.

By: /s/ ALEX KAPLAN
Alex Kaplan
Vice President.
Mexico City

AGREEMENT

THIS TECHNICAL AGREEMENT, entered into this 6th day of December, 1963, by and between CONTAINER CORPORATION OF AMERICA, a Delaware corporation having offices at 38 South Dearborn Street, Chicago 3, Illinois, U.S.A. (hereinafter referred to as "CONTAINER") and N. V. "MERCURIUS" GOLFCARTONINDUSTRIE, domiciled at Soest, The Netherlands (hereinafter referred to as "MERCURIUS").

RECITALS

I. CONTAINER is engaged in the manufacture and sale of paperboard products including corrugated and fibre shipping containers, and because it has been operating in these industries for a long period of time it has accumulated much technical information and experience of value and assistance to other corporations engaged in similar industrial activities.

II. MERCURIUS is engaged in the same industry as CONTAINER. In order to develop its business on the Dutch market, MERCURIUS wishes to utilize the experience accumulated by CONTAINER in the industry as referred to in Recital I hereof by obtaining the assistance of CONTAINER, for which assistance MERCURIUS is willing to pay CONTAINER in accordance with the terms of this Agreement.

CLAUSES

FIRST: CONTAINER binds itself to perform special services and to provide advice and consultation to MERCURIUS concerning machinery, equipment, and produc-

tion, and to render any other assistance which MERCURIUS may require in connection with any aspect of its industrial or commercial operations.

SECOND: In order that MERCURIUS may receive in an efficient manner the advice and consultation referred to in the preceding paragraph, CONTAINER will furnish MERCURIUS with all technical bulletins and other material that CONTAINER uses in the United States which MERCURIUS may require from time to time. CONTAINER will also undertake to answer the requests of MERCURIUS for assistance in these areas of business activity by correspondence as well as by visits of qualified personnel to The Netherlands.

THIRD: If technicians of CONTAINER are sent from the United States MERCURIUS will pay for transportation expenses and MERCURIUS will be responsible for the cost of reasonable living expenses which may be involved in the visit of these employees while in The Netherlands. MERCURIUS will pay for all travelling and living expenses which occur when MERCURIUS employees are sent to the United States for training.

FOURTH: MERCURIUS shall not have the right to pass the information received from CONTAINER on to third parties, but only to use it for its own purposes.

FIFTH: For the services rendered under this contract MERCURIUS shall pay CONTAINER a monthly fee of Five Hundred U.S. Dollars ($500.00). The first payment under this contract will be made upon the execution and delivery of this Agreement and will cover services rendered

by CONTAINER during the month of October, 1963. Subsequent monthly payments will be made within thirty (30) days following the close of each month during the life of this Agreement.

SIXTH: This Agreement is made between CONTAINER and MERCURIUS for the period commencing October 1, 1963 and terminating September 30, 1964. It will continue in effect for successive one year periods thereafter unless either party gives written notice to the other at least three (3) months prior to the expiration of the then current contract period.

SEVENTH: This contract can be modified only by written agreement between the two parties.

EIGHTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves to the laws and courts of the City of Chicago, Illinois, United States of America, or those of the City of Soest, The Netherlands.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their appropriate officers.

CONTAINER
CORPORATION
OF AMERICA

Chicago, Illinois

ATTEST:

By /s/
Senior Vice President

/s/
Assistant Secretary

Soest, The Netherlands

N.V. "MERCURIUS"
GOLFCARTON-
INDUSTRIE

WITNESS:

/s/
Plant Controller

By /s/
General Manager

AGREEMENT

THIS TECHNICAL SERVICE AGREEMENT, entered into this 23rd day of October, 1963, by and between CONTAINER CORPORATION OF AMERICA, a Delaware corporation having offices at 38 South Dearborn Street, Chicago 3, Illinois, U.S.A. (hereinafter referred to as "CONTAINER") and EUROPA CARTON AKTIENGESELLSCHAFT, domiciled at Hamburg 36, Germany, Neuer Wall 3 (hereinafter referred to as "ECA")

RECITALS

I. CONTAINER is engaged in the manufacture and sale of paperboard products including boxboard, containerboard, corrugated and fibre shipping containers, and folding cartons, and consequently, because it has been operating in these industries for a long period of time, has accumulated much valuable experience to furnish technical assistance to corporations engaged in equal or similar industrial activities.

II. ECA and its subsidiaries are engaged in the same industries as CONTAINER. In order to develop its business on the German market, ECA wishes to partake of the experiences accumulated by CONTAINER in the industries as referred to in Recital I hereof by requiring assistance of CONTAINER, for which assistance ECA is willing to pay pursuant to this Agreement.

CLAUSES

FIRST: CONTAINER binds itself to perform services and to provide advice and consultation to ECA concerning manufacturing techniques, engineering, design, architec-

ture, insurance and cost accounting in accordance with CONTAINER's progress in these areas, and to render any other assistance which ECA may require in connection with any aspect of its industrial or commercial operations.

In order that ECA may receive in an efficient manner the advice and consultation referred to in the preceding paragraph, CONTAINER will furnish ECA with all technical bulletins and other material that CONTAINER uses in the United States and that ECA may require from time to time. CONTAINER will undertake to answer ECA's requests for assistance in these areas by correspondence as explicit as ECA may require, and besides, at the request of ECA, it shall send qualified personnel to Germany or train employees of ECA.

SECOND: If technicians are sent from the United States, CONTAINER will pay for transportation expenses and ECA will be responsible for the cost of reasonable living expenses which may be involved in the visit of these employees in Germany. ECA will pay for all travelling and living expenses which occur when ECA employees are sent to the United States for training.

THIRD: ECA shall not have the right to pass the information received from CONTAINER on to third parties, but only to use it for its own ends.

FOURTH: For the services rendered under this contract ECA shall pay CONTAINER a fee of thirty-five hundredths percent (0.35%) of ECA trade sales. Payment will be made at the end of each month and be based on ECA's trade sales of the preceding month. The first payment will be made on the trade sales of July, 1963.

FIFTH: This agreement is made between CONTAINER and ECA for the period July 1, 1963 to June 30, 1964. It will continue in effect for each one year thereafter unless one party makes written notice three months prior to the end of any period.

SIXTH: This contract can be modified only by written agreement between the two parties.

SEVENTH: For the interpretation and performance of this Agreement, the parties hereto shall submit themselves to the laws and courts of the City of Chicago, Illinois, United States of America, or those of the City of Hamburg, Germany.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their appropriate officers.

Chicago, Illinois

ATTEST:

CONTAINER CORPORATION OF AMERICA

/s/
Assistant Secretary

By /s/
Senior Vice President

Hamburg

WITNESS:

EUROPA CARTON AKTIENGESELLSCHAFT

/s/

By /s/
Chairman of the Management Committee

[Jurat omitted in printing]

EXHIBIT L

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year 1963

Or other taxable year beginning ..... , 19..... , and ending ..... , 19 .....

NAME	ADDRESS (Number and street, city or town, postal zone number, State)	EMPLOYER IDENTIFICATION NO.
Container Corporation of America	38 South Dearborn Street, Chicago, Illinois - 60603	36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See inst. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(6) (b) Conversion rate	(6) (c) In dollars
A	Canada		1963	Income	Canadian Income Tax Act	16,667.96	2,779.50	.9278	2,578.86
B	Colombia		1963	Income	Decree 1987 & Law 21 (1963)	118,967.89	167,616.10	.10012	16,732.03
C					Decree 437(1961)Law 81(1960)				
D	Mexico		1963	Income	Ley del Impuesto Sobre la Renta	44,100.00	-	-	17,640.00
E	Netherlands		1963	Income	Corporation Tax Act-1962	550,639.33	-	-	-
F	Ireland		1963			6.59	-	-	-
G	Australia		1963	Income	Assessment Act (1941) - Treaty (1953)	2,051.40	422.10.7	2.226	718.00
H	German Fed. Republic		1963	Income	Corporation and Business Tax	285,944.59	101,354.20	.2513	25,471.21
	Venezuela		1963			28,664.00			-
	Also use this line for computation of overall limitation only				TOTALS	1,046,141.76			63,190.10
	INTEREST (See instruction J)								
					TOTALS	1,046,141.76			63,190.10

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C								
D								
E		1962						
F								
G								
H								
TOTALS	46,234.54	19,545.95	528,970.59	13,579,903.25	26,666,747.72	3.92414	532,894.42	528,970.59
INTEREST								
TOTALS	46,234.54	19,545.95	528,970.59	13,579,903.25	26,666,747.72	3.92414	532,894.42	528,970.59

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (See instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See Inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
Carton de Colombia, S. A.	1962	Colombia, S. A.	3,564,274	1,545,879	2,018,395	17,811	875,408	-	875,408	7,724.60
	1963	Colombia, S. A.	5,164,638	2,508,036	2,656,602	101,157	1,290,091	-	1,290,091	49,124.09
Bremer Papier und Wellpappen Fabrik, A.G.	1963	German Federal Republic	445,426	249,720	195,706	137,775 107,976	137,775	-	137,775	137,775.34
N. V. Mercurius Golfcartonindustrie	1963	The Netherlands	359,445	161,750	197,695	161,750 197,695	161,750	-	161,750	161,750.44
	1962	The Netherlands	344,669	161,993	182,676	61,833	85,356	-	85,356	29,061.02
	1961	The Netherlands	310,491	145,930	164,561	129,361	77,343	-	77,343	60,799.05
					TOTAL	915,358				446,234.54

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year ~~1964~~

Or other taxable year beginning ..... , 19..... , and ending ..... , 19 .....

NAME: CONTAINER CORPORATION OF AMERICA

ADDRESS (Number and street, city or town, postal zone number, State): 38 South Dearborn Street, Chicago, Illinois 60603

EMPLOYER IDENTIFICATION NO.: 36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See instr. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(6) (b) Conversion rate	(6) (c) In dollars
A		Schedule							
B									
C			Attached			Schedule			
D							Attached		
E									
F									
G									
H									
	Use this line for computation of overall limitation only				TOTALS	3,137,279.48			258,333.06
INTEREST (See instruction J)	Canada			1964 Income Canadian Income Tax Act		106,418.49			15,962.77
					TOTALS	3,243,697.97			274,295.83

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C								
D								
E								
F								
G								
H								
TOTALS	1,232,678.00	- 0 -	1,491,011.06			10.3882 %	1,531,493.88	1,491,011.06
TOTALS INTEREST	- 0 -		15,962.77			0.3524%	51,953.03	15,962.77
TOTALS	1,232,678.00		1,506,973.83	14,742,629.92	20,200,299.74	10.7406 %	1,583,446.91	1,506,973.83

935 170

FORM 1118 (Rev. April 1963)

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (See instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED * PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
			Schedule							
				Attached						
					TOTAL	2,278,616.00				1,232,678

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

U S GOVERNMENT PRINTING OFFICE : 1963 OF—677215

CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118
Controlled Foreign Corporations - Earnings and Profits Data
(Statement Required by T.I.R. 651)

Name and Address of Controlled Foreign Corporation (Note (2))	Country of Incorporation	Total Gross Income	Total Deductions	Total Income, and Excess Profits Taxes	Earnings & Profits	1964 Subpart F Income	Previously Excluded Subpart F Income
Cartoenvases de Mexico, S. A. Lago Chapala 26 P Colonia Anahuac, Mexico, D. F.	Mexico	$ 587,893	$ 390,333	$ 105,383	$ 92,177	$ Note (1)	$
Carton y Papel de Mexico, S. A. Melchor Ocampo 463, Desp. 102, Mexico, D. F.	Mexico	2,398,718	887,430	690,823	820,365	Note (1)	
Carton de Colombia, S. A. Apartado Aereo 219, Cali, Colombia, S. A.	Colombia	6,486,313	1,628,127	2,553,755	2,304,431	Note (1)	
Carton de Venezuela, S. A. Apartado 609, Caracas, Venezuela, S. A.	Venezuela	2,629,911	424,423	808,010	1,397,478	Note (1)	
Cartones Nacionales, S. A. Apartado 1829, Edificio Easo, 12/C, Avenida Francisco de Miranda, Caracas, Venezuela	Venezuela	2,028,311	697,998	415,211	915,102	Note (1)	
Celulosa y Papel de Colombia Edificio Seguros Bolivar - 408, Carrera 10 No. 16-39, Bogata, D. E. Colombia	Colombia	104,111	107,936	--	(3,825)		
Corrugadora de Carton, S. A. Apartado 609, Caracas, Venezuela, S. A.	Venezuela	951,058	341,481	158,130	451,447	Note (1)	
Fibras Industriales de Venezuela Edificio Easo 3-1, Avenida Francisco de Mirando, Chacaito, Caracas, Venezuela	Venezuela	110,704	95,600	4,583	10,521	Note (1)	
Union Grafica, S. A. Apartado 3315, Catia - Caracas, Venezuela	Venezuela	479,443	176,736	67,692	235,015	Note (1)	

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CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118
Controlled Foreign Corporations - Earnings and Profits Data
(Statement Required by T.I.R. 651) (Continued)

Name and Address of Controlled Foreign Corporation (Note (2))	Country of Incorporation	Total Gross Income	Total Deductions	Total Income, and Excess Profits Taxes	Earnings & Profits	1964 Subpart F Income	Previously Excluded Sub-part F Income
Carton Internacional, S. A. Avenida Central No. 16-A, Panama, R. de P.	Panama	$ 1,213,932	$ 42,184	$ -	$1,171,748	$1,171,748	$ 240,567
Europa Carton Austria Konstantingasse 6-8, Vienna, Austria	Austria	(52,986)	5,107		(58,093)		
Bremer Papier und Wellpappenfabrik Lubbecke, Westfallen, Germany	Germany	791,061	275,873	268,504	246,684	Note (1)	
Europa Carton, A. G. 3 Neuer Wall, Hamburg 36, Germany	Germany	2,311,905	1,432,721	361,590	517,594	Note (1)	
Cartiera Europa Carton Isoletta Sul Liri (Frosinoni), Italy	Italy	49,843	102,486	-	(52,643)		
Cartotecnica Europa Carton Orsenigo (Como), Italy	Italy	410,864	290,797	47,551	72,516	Note (1)	
Europa Carton Italiana, S.p.A Via Turati 6 - Milan, Italy	Italy	350	(87)	1,794	(1,357)		
Industrie Elecctromeccaniche Metalluriche Orsenigo (Como), Italy	Italy	(18,273)	(10,680)	1,295	(8,888)		
VOSA, S.p.A. Via Serravalle 35 bis, Novi Liguri, Italy	Italy	620,544	747,665	14,390	(141,511)		
N.V. Mercurius Golfcartonindustrie Kostverlorenveg, Soest, The Netherlands	Netherlands	616,090	218,969	199,689	197,432	Note (1)	

Note (1) Derives substantially all its income from the sale of goods manufactured in country of incorporation.
(2) Taxable year of all controlled foreign corporations is calendar year.

CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118 - Schedule A

(1) Name of Foreign Country Imposing Tax	(2) Credit Claimed for Taxes (Date Accrued)	(3) Type of Tax	(4) Statute Imposing Tax	(5) Taxable Income	(6)(C) Taxes Paid or Accrued
Australia	1964	Income	Assessment Act (1941) Tax Treaty (1953)	$ 1,844.92	$ 645.72
Canada	1964	Income	Canadian Income Tax Act	11,421.09	3,637.08
Colombia	1964	Income	Decree 1987 and Law 21 (1963) Decree 437 (1961) Law 81 (1960)	260,407.08	26,022.00
German Federal Republic	1964	Income	Corporation and Business Tax	953,110.98	94,974.45
Italy	-	-	---	2,552.85	-
Mexico	1964	Income	Mexican Income Tax Act	96,426.85	40,239.66
Netherlands	1964	Income	Corporation Tax Act-1962	326,003.42	-
United Kingdom	-	-	---	49.47	-
Venezuela	1964	Income	Venezuela Income Tax Law	73,147.82	858.15
				$ 1,724,964.48	$ 166,377.06
Sec. 951 (a) (1) (A) (i) - Subpart F Income - 1964				1,171,748.00	81,888.00
Sec. 951 (a) (1) (A) (ii) - Subpart F. Income Withdrawn from Investment in Less Developed Countries - 1964				240,567.00	10,068.00
Total - for Computation of Overall Limitation				$ 3,137,279.48	$ 258,333.06

CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118 - Schedule B

(1) Name of Related Foreign Corporation	(2) Year	(3) Incorporated Under the Laws of	(4) Gains, Profits, and Income of For. Corp.	(5) Foreign Tax Paid or Accrued	(6) Accumulated Profits	(7) Dividends Paid or Constructively Received	Dividends After Gross-Up	(8) For. Tax Paid on Accumulated Profits	(11) Tax Deemed to Have Been Paid
Carton de Colombia, S. A.	1964	Colombia	$ 4,858,186	$ 2,553,755	$ 2,304,431	$ 165,515		$ 1,211,348	$ 87,005
	1963	"	5,178,342	2,504,505	2,673,837	27,586		1,293,201	13,342
Europa Carton, A. G.	1964	German Fed. Republic	879,184	361,590	517,594	387,500	658,207		270,707
Bremer Papier u. Wellpappenfabrik,A.G.	1964	" "	515,188	268,504	246,684	107,460	224,425		116,965
N. V. Mercurius	1964	Holland	397,121	199,689	197,432	160,196	322,224		162,028
						$ 848,257	$1,204,856		$ 650,047
Constructive Distributions under Section 951 (a) (1) (A) (i) - Personal Holding Company Income (Dividends) Received in 1964 by Carton Internacional, S. A. (Panama) from Related Controlled Foreign Corp.									
Carton de Colombia, S.A.	1964	Colombia	4,858,186	2,553,755	2,304,431	504,000		1,211,348	264,933
	1963	"	5,178,342	2,504,505	2,673,837	84,000		1,293,201	40,627
Carton de Venezuela, S. A.	1964	Venezuela	2,205,488	808,010	1,397,478	355,520		511,985	130,249
Union Grafica, S. A.	1964	"	302,707	67,692	235,015	70,393		52,555	15,741
Corrugadora de Carton, S. A.	1964	"	609,577	158,130	451,447	175,982		117,110	45,651
						$ 1,189,895			$ 497,201
Constructive Distributions under Section 951 (a) (1) (A) (ii) -Subpart F Income Received and Reinvested By Carton Internacional in 1963, withdrawn from Investment in Less Developed Countries in 1964.									
Carton de Colombia, S. A.	1963	Colombia	5,178,342	2,504,505	2,673,837	60,277		1,293,201	29,153
	1962	"	3,954,361	1,730,701	2,223,660	10,716		973,227	4,690
Carton de Venezuela, S. A.	1963	Venezuela	1,332,642	410,372	922,270	117,655		284,002	36,231
	1961	"	1,236,695	348,211	888,484	20,638		250,167	5,811
Union Grafica, S.A.	1963	"	97,853	39,916	57,937	7,391		23,634	3,015
	1958	"	340,742	53,374	287,368	3,672		45,013	575
Corrugadora de Carton, S.A.	1963	"	392,818	116,282	276,536	20,115		81,860	5,955
						$ 240,464			$ 85,430
			Grand Total			$ 2,278,616			$1,232,678

CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118
Controlled Foreign Corporations - Subpart F Income
(Statement Required by T.I.R. 651)

I.	Carton Internacional, S. A., Subpart F Income - 1964		
	Personal Holding Company Income:		
	Dividends from Related Companies -		
	Carton de Colombia, S. A.	$ 588,000	
	Union Grafica, S. A.	70,393	
	Corrugadora de Carton, S. A.	175,982	
	Carton de Venezuela, S. A.	355,520	
	Other Dividends - Miscellaneous	553	
	Interest Income	16,271	
	Exchange Gains	7,213	$1,213,932
	Related Expenses:		
	Losses on Exchange	$ 14,292	
	Legal and Accounting Fees	271	
	Miscellaneous Expenses	12,621	(42,184)
	Net Personal Holding Company Income - 1964		$1,171,748
II.	Carton Internacional, S. A., Previously Excluded Subpart F Income Withdrawn from Investment in Less Developed Countries:		
	Qualified Investments in Less Developed Country Corporations as of -		
	December 31, 1963		$12,662,492
	December 31, 1964		12,421,925
	Decrease		$ 240,567

CONTAINER CORPORATION OF AMERICA

U. S. Corporation Income Tax Return
Calendar Year 1964

Schedule Attached to and Made a Part of Form 1118
Controlled Foreign Corporations - Subpart F Income (Cont'd.)
(Statement Required by T.I.R. 651)

		Qualified Reinvestments 1963	Investments Withdrawn 1964
Personal Holding Company Income - 1963			
Dividends from Related Companies -			
Carton de Colombia, S. A.	$ 445,200		$ 70,993
Union Grafica, S. A.	69,379		11,063
Corrugadora de Carton, S. A.	126,144		20,115
Carton de Venezuela, S.A.	867,240		138,293
Other Dividends	529		84
Interest Income	3,701		591
Exchange Gains	3,680	1,515,873	588
Related Expenses:			
Losses on Exchange	5,300		(845)
Legal and Accounting Fees	329		(52)
Interest Expense	1,649	(7,278)	(263)
Net Personal Holding Company Income - 1963		$1,508,595	$ 240,567

Summary of Pages 1, 2 and 3

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year 1965

Or other taxable year beginning ....., 19....., and ending ....., 19 .....

NAME	ADDRESS (Number and street, city or town, postal zone number, State)	EMPLOYER IDENTIFICATION NO
Container Corporation of America	38 South Dearborn Street, Chicago, Illinois - 60603	36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See inst. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(b) Conversion rate	(c) In dollars
A									
B				Summary	- Page 1	1,786,610.83			139,574.63
C				Summary	- Page 2	2,485,125.00			97,395.00
D				Summary	- Page 3	1,268,644.00			53,063.00
E									
F									
G									
H									
	Use this line for computation of overall limitation only				TOTALS	5,540,379.83			290,332.63
	INTEREST (See instruction J)			Summary	- Page 1	137,565.78			21,584.09
				Summary	- Page 2	26,397.00			-
				Summary	- Page 3	(616.00)			-
					TOTALS	5,703,726.61			311,916.72

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C	715,562	Page 1	855,136.63					
D	953,720	Page 2	1,051,415.00					
E	450,299	Page 3	503,362.00					
F								
G								
H								
TOTALS	2,119,581		2,409,913.63	16,951,883.63	35,975,903.62	15.40025	2,610,632.46	2,409,913.63
INTEREST	-	Page 1	21,584.09	16,951,883.63	35,975,903.62	0.38238	64,820.61	21,584.09
	-	Page 2	-					
	-	Page 3	-					
TOTALS	2,119,581		2,431,497.72	16,951,883.63	35,975,903.62			2,431,497.72

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (S
instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
					Summary Page 1					
					Summary Page 2					
					Summary Page 3					
					TOTAL					

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

U.S. GOVERNMENT PRINTING OFFICE : 1963 O—672215

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year 1965

Or other taxable year beginning ....., 19....., and ending ....., 19 .....

NAME	ADDRESS (Number and street, city or town, postal zone number, State)	EMPLOYER IDENTIFICATION NO.
Container Corporation of America	38 South Dearborn Street, Chicago, Illinois - 60603	36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See inst. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(6) (b) Conversion rate	(6) (c) In dollars
A	Australia		1965	Income	Assessment Act (1941)	3,198.83			1,199.56
B	Canada		1965	Income	Canadian Income Tax Act	16,817.44			2,429.35
C	Colombia		1965	Income	Law 81 (1960) Decree 437	209,092.09			18,544.67
D					(1961) Decree 2323 (1965)				
E	German Fed. Republic		1965	Income	Corp. and Business Tax	1,076,229.93			69,119.54
F	Mexico		1965	Income	Mexican Income Tax Act	103,047.54			48,281.21
G	Netherlands		1965	Income	Corporation Tax Act - 1962	320,100.00			-
H	Italy	-	-	-	-	14,625.00			-
	Venezuela	-	-	-	-	43,500.00			-
	Use this line for computation of overall limitation only				TOTALS	1,786,610.83			139,574.63
INTEREST (See instruction J)	Canada					137,565.76			21,584.09
					TOTALS	1,924,176.61			161,158.72

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C								
D					Refer to Summary Sheet			
E								
F								
G								
H								
TOTALS	715,562		855,136.63					
INTEREST								
			21,584.09					
TOTALS	715,562		876,720.72					

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (See instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
Carton de Colombia	'65	Colombia	2,612,619	1,484,104	1,128,515	329,042	641,056		641,056	186,913
Carton de Colombia	'64	Colombia	4,858,186	2,553,755	2,304,431	77,614	1,211,348		1,211,348	40,799
Carton de Venezuela	'65	Venezuela	2,599,437	332,257	1,667,180	764,368	597,914		597,914	274,131
Union Grafica	'65	Venezuela	422,292	128,115	294,177	106,656	89,247		89,247	32,357
Corrugadora de Carton	'65	Venezuela	746,938	234,542	512,396	355,520	160,895		160,895	111,635
Cartones Nacionales	'65	Venezuela	1,628,677	479,184	1,149,493	364,408	338,200		338,200	107,215
Cartoenvases de Mexico	'65	Mexico	152,029	62,374	89,655	89,655	36,783		36,782	36,783
Cartoenvases de Mexico	'64	Mexico	197,560	93,792	103,768	103,768	49,264		49,264	49,264
Cartoenvases de Mexico	'63	Mexico	28,581	951	27,630	27,630	919		919	919
Cartoenvases de Mexico	'62	Mexico	221,270	83,257	138,013	54,804	51,930		51,930	20,621
Carton y Papel	'65	Mexico	2,129,038	988,412	1,140,626	200,500	529,539		529,539	93,083
					TOTAL	2,473,965				953,720

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

U.S. GOVERNMENT PRINTING OFFICE : 1963 OF—677215

Part 2 - "Subpart F" Income Under Sec. 951(a)(1)(A)(i) - Carton Internacional, S. A. (Panama)

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year 1965

Or other taxable year beginning ..... , 19..... , and ending ..... , 19 .....

NAME	ADDRESS (Number and street, city or town, postal zone number, State)	EMPLOYER IDENTIFICATION NO.
Container Corporation of America	38 South Dearborn Street, Chicago, Illinois - 60603	36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See inst. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(6) (b) Conversion rate	(6) (c) In dollars
A	Colombia		1965	Income	Law 81 (1960) Decree 437	417,181			54,630
B					(1961) Decree 2323 (1965)				
C	Mexico		1965	Income	Mexican Income Tax Act	476,357			43,065
D	Venezuela		1965	Income	Venezuelan Income Tax Law	1,590,750			
E	Italy					243			
F	Austria					834			
G	Panama					(240)			
H									
	Use this line for computation of overall limitation only				TOTALS	2,485,125			97,695
	INTEREST (See instruction 1): Miscellaneous - U. S. Source Income					26,397			
					TOTALS	2,511,522			97,695

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C								
D								
E				Refer to Summary Sheet				
F								
G								
H								
TOTALS	953,720	-	1,051,415					
INTEREST								
TOTALS	953,720		1,051,415					

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (See instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
Carton de Colombia,S.A.	'65	Colombia	2,612,619	1,484,104	1,128,515	108,090	641,056	-	641,056	61,401
	'64	Colombia	4,858,186	2,553,755	2,304,431	25,498	1,211,348	-	1,211,348	13,403
Europa Carton, A.G.	'65	German Fed. Republic	2,320,105	1,142,554	1,177,551	387,500				375,984
						375,984	Gross Up			
Bremer Papier und Wellpappenfabrik,A.G.	'65	German Federal Republic	587,880	294,500	293,380	107,460				107,870
						107,870	Gross Up			
N. V. Mercurius	'65	Netherlands	431,444	213,483	217,961	160,196				156,904
						156,904	Gross Up			
					TOTAL	1,429,502				715,562

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

U.S. GOVERNMENT PRINTING OFFICE : 1963 OF—677215

Page 3 - "Subpart F Income" under Sec. 951(a)(1)(A)(ii) - Withdrawn from Investment in Less Developed Countries

FORM 1118
(Rev. April 1963)
U.S. Treasury Department
Internal Revenue Service

STATEMENT IN SUPPORT OF CREDIT CLAIMED BY DOMESTIC CORPORATION FOR TAXES PAID OR ACCRUED TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES

For Calendar Year 1965

Or other taxable year beginning ....., 19....., and ending ....., 19 .....

NAME	ADDRESS (Number and street, city or town, postal zone number, State)	EMPLOYER IDENTIFICATION NO.
Container Corporation of America	38 South Dearborn Street, Chicago, Illinois - 60603	36-0947030

SCHEDULE A.—If the per-country limitation is elected, fill in columns 1 through 14, line by line; use total line only for column 14. If the overall limitation is elected, fill in columns 1 through 6, line by line including total line; use total line only for columns 7 through 14. Computation (lines A through H) is made under: ☐ per-country limitation, ☒ overall limitation.

LINE	(1) NAME OF FOREIGN COUNTRY OR U.S. POSSESSION IMPOSING TAX (Use a separate line for each)	(2) CREDIT CLAIMED FOR TAXES: Date paid	(2) CREDIT CLAIMED FOR TAXES: Date accrued	(3) TYPE OF TAX	(4) STATUTE IMPOSING TAX (Title, number, section, etc.)	(5) TAXABLE INCOME (OR LOSS) (Income from sources without the U.S. less allocable deductions. See inst. for gross-up of dividends)	(6) TAXES PAID OR ACCRUED (Attach receipt or return): (a) In foreign currency	(6) (b) Conversion rate	(6) (c) In dollars
A	Colombia		1963	Income	Law 81 (1960) Decree 437	370,197			52,860
B					(1961) Decree 1987 and				
C					Law 21 (1963)				
D	Venezuela		1963	Income	Venezuelan Income Tax Law	898,226			
E	Mexico		1963	Income	Mexican Income Tax Act	498			203
F	Panama					(277)			
G									
H									
	Use this line for computation of overall limitation only				TOTALS	1,268,644			53,063
	INTEREST (See instruction 3): Miscellaneous - U. S. Source					(616)			
					TOTALS	1,268,028			53,063

LINE	(7) TAX DEEMED TO HAVE BEEN PAID (From column 11, schedule B)	(8) CARRYBACK OR CARRYOVER (Attach schedule)	(9) TOTAL FOREIGN TAXES (Sum of columns 6c, 7, and 8)	(10) TOTAL U.S. INCOME TAX REPORTED ON FORM 1120	(11) TAXABLE INCOME FROM ALL SOURCES (Reported on Form 1120)	(12) COLUMN (5) DIVIDED BY COLUMN (11)	(13) LIMITATION (Column (10) multiplied by column (12))	(14) CREDIT (Column (13) or column (9) whichever is less)
A								
B								
C								
D								
E				Refer to Summary Sheet				
F								
G								
H								
TOTALS	450,299		503,362					
TOTALS INTEREST								
TOTALS	450,299		503,362					

SCHEDULE B.—Taxes paid or accrued to a foreign country or a possession of the United States by (1) a related foreign corporation or (2) a related domestic corporation entitled to the benefits of section 931 or 941 (See instructions). For constructive distributions under section 951, attach schedule showing computation of credit under section 960.

(1) NAME OF RELATED FOREIGN CORPORATION	(2) YEAR (See inst.)	(3) INCORPORATED UNDER THE LAWS OF (Name of country)	(4) GAINS, PROFITS, AND INCOME OF FOREIGN CORP. FOR YEAR FROM WHICH DIVIDENDS WERE PAID	(5) FOREIGN TAX PAID OR ACCRUED ON GAINS, PROFITS, AND INCOME IN COLUMN (4) (Attach receipt or return)	(6) ACCUMULATED PROFITS (Column (4) minus column (5))	(7) DIVIDENDS PAID BY RELATED FOREIGN CORPORATION	(8) FOREIGN TAX PAID ON ACCUMULATED PROFITS (Column (6) ÷ column (4) × column (5)) (See inst. for distributions after 1962.)	(9) TAX DEEMED PAID BY RELATED FOREIGN CORPORATION (Schedule C, column (11))	(10) TOTAL OF COLUMN (8) PLUS COLUMN (9)	(11) TAX DEEMED TO HAVE BEEN PAID (Column (7) ÷ column (6) × column (10))
Carton de Colombia	'63	Colombia	5,178,342	2,504,505	2,673,837	317,723	1,293,201		1,293,201	153,667
Carton de Colombia	'62	Colombia	3,954,361	1,730,701	2,223,660	56,484	973,227		973,227	24,721
Carton de Venezuela	'63	Venezuela	1,332,642	410,372	922,270	620,161	284,002		284,002	190,971
Carton de Venezuela	'61	Venezuela	1,236,695	348,211	888,484	108,786	250,167		250,167	30,630
Union Grafica	'63	Venezuela	97,853	39,916	57,937	38,959	23,634		23,634	15,892
Union Grafica	'58	Venezuela	340,742	53,374	287,368	19,357	45,013		45,013	3,032
Corrugadora de Carton	'63	Venezuela	392,818	116,282	276,536	106,029	81,860		81,860	31,386
					TOTAL	1,267,499				450,299

SCHEDULE C.—The following lines are for the computation of taxes deemed to have been paid by a related foreign corporation in respect of dividends from its foreign subsidiary—Column headings same as Schedule B.

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No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal
of the State of California for the
First Appellate District

MOTION OF APPELLEE TO DISMISS OR AFFIRM

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TABLE OF CONTENTS

	Pages
QUESTION PRESENTED BY APPELLANT	2-3
STATEMENT OF THE CASE	4-13
NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED: NO FURTHER ARGUMENT IS REQUIRED	14-35
A. CONTAINER CORPORATION'S FOREIGN SUBSIDIARIES ARE PART OF ITS UNITARY BUSINESS	14-20
B. FORMULA APPORTIONMENT IS PROPER FOR INTERNATIONAL AS WELL AS INTERSTATE UNITARY ENTERPRISES	21-23
C. WHERE A BUSINESS IS UNITARY, ANALYSES BASED ON SEPARATE ACCOUNTING PRINCIPLES DO NOT PRECLUDE FORMULA APPORTIONMENT	23-25
D. THE JAPAN LINE CASE DOES NOT REQUIRE USE OF SEPARATE ACCOUNTING	25-35
1. NO FEDERAL "ONE VOICE" POLICY PRECLUDES FORMULA APPORTIONMENT OF INCOME:	28-29

TABLE OF CONTENTS
(Continued)

	Pages
2. THERE IS NO UNCONSTITUTIONAL DOUBLE TAXATION:	29-35
CONCLUSION	35-40

TABLE OF AUTHORITIES CITED

Cases

Federal:	Pages
Bass, Etc., Ltd. v. Tax Com. (1924) 266 U.S. 271	21,22
Exxon Corp. v. Department of Revenue of Wisconsin (1980) 447 U.S. 207	25,29,35 39
Grayson v. Harris (1924) 267 U.S. 352	16
International Harvester Co. v. Evatt (1947) 329 U.S. 416	27
Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434	12,25,26, 28,32,33, 34,36,37
Mobil Oil Co. v. Vermont (1980) 445 U.S. 425	14,15,16, 21,22,23, 25,27,28, 29,35,36, 37,39
State:	
Container Corp. of America v. Franchise Tax Bd. (1981) 117 Cal.App.3d 988	3

TABLE OF AUTHORITIES CITED
(Continued)

Cases

State:	Pages
Butler Bros. v. McColgan (1941) 17 Cal.2d 664	15
Edison California Stores v. McColgan (1947) 60 Cal.2d 406	15
Superior Oil Company v. Franchise Tax Board (1961) 60 Cal.2d 406	14

Constitution

U.S. Const. art. I, § 8, cl. 3	3
U.S. Const. amend. XIV	3

Statutes

Title 18, Cal. Administrative Code, § 25120(b)	3
Cal. Rev. & Tax. Code § 25101	3

No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

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On Appeal from the Court of Appeal
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First Appellate District

The appellee (hereinafter sometimes FTB) moves the Court to dismiss the appeal herein or in the alternative to affirm the judgment below under Rule 16.1 on the grounds that the appeal does not present a substantial federal question; the questions on which the decision of the cause depends are so unsubstantial as to not need further arguments; the judgment rests on an adequate non-federal

basis (factual determinations made under California rules of evidence) and the specific question sought to be reviewed in the jurisdictional statement was not properly raised in the state courts from which an appeal is taken.

QUESTION PRESENTED BY APPELLANT

"Whether requiring the income of foreign subsidiaries of a domestic corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the foreign commerce and due process clauses of the federal constitution, and in conflict with well established federal tax policy, when:

"1. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries; and

"2. The inclusion of the foreign subsidiary income in the parent's unitary tax base results

in a significant distortion of the parent's taxable income and double taxation of the foreign subsidiary income through misattribution of that income to California."

(See Jurisdictional Statement p. (i).)

The decision appealed from appears in Appendix A to the Jurisdictional Statement and is reported at Container Corp. of America v. Franchise Tax Bd. (1981) 117 Cal.App.3d 988, 173 Cal.Rptr. 121. CCA refers to California Revenue and Taxation Code section 25101 (as it provided 1963-65), Title 18, California Administrative Code section 25120(b) (in Appendix G) and the "Foreign Commerce Clause" (U.S. Const. art. I, § 8, cl. 3) and the "Due Process Clause of the Fourteenth Amendment" as the constitutional, statutory and regulatory provisions which this case involves. (Jurisdictional Statement pp. 2-3.)

STATEMENT OF THE CASE

The Jurisdictional Statement (pp. 3-7) contains substantial misstatements of the proceedings before the California courts and the evidence of unity presented in this case.

CCA correctly states that California apportions income according to the familiar and long used "property, payroll and sales" formula in determining net income of corporations taxable by California where such corporations engage in a unitary business in foreign countries through use of subsidiaries as well as when the unitary business is conducted solely within the United States or the portion of the unitary business conducted outside the United States is conducted by the corporation itself.

CCA states that it here challenges the constitutionality of

including the taxpayer's foreign subsidiaries in the unitary business group where (CCA asserts) "the foreign subsidiary is not functionally integrated with the parent and misattribution of income to the parent results and where the California method contradicts federal tax policy." (Jurisdictional Statement p. 4; see also "Question Presented" quoted above.) CCA totally ignores the determinations made by both the trial court and the Court of Appeal that CCA and its foreign subsidiaries constituted a unitary enterprise. In fact, most of the appellate court decision dealt with this issue (see Appendix A-1 to A-18 to Jurisdictional Statement). The California Court of Appeal extensively discussed some of the facts of CCA'S international operations which caused that court to conclude that they were part of its unitary

business. The "STATEMENT" in the Jurisdictional Statement ignores these facts. It recites "facts" inaccurately.

Among the facts which show the unitary nature of CCA'S international operations, which CCA would have this Court consider insubstantial or ignore entirely are the following:

1. CCA and its subsidiaries were all engaged in the same (paperboard/packaging) business (CT 194, 197, 199, 221). CCA began operations in each foreign country (except Holland) by creating its own company. (CT 194.) Its foreign activities would not even exist but for extensive activity by CCA, especially during the earlier years of business in those countries. (CT 221-224.) These operations, having been created by the expertise and financial strength of CCA began as an integral part of its

unitary business. Do not become non-unitary once they have received all these benefits merely because they no longer need day-to-day direction of business details and the former CCA employees who manage and operate the business are placed on the local payroll. CCA's contributions continue to benefit the foreign subsidiaries. (Such contributions by CCA are not reflected in the separate accounting method which CCA asks this Court to require.)

2. CCA handles its foreign subsidiaries like its domestic (concededly unitary) operations (decentralized; CT 193, 198, 209-210). CCA maintains control and participates in decisions it considers important. (CT 196, 220.) The CCA personnel (present and former) working at the foreign subsidiaries were in <u>key management</u> positions and controlled the

operational decisions of the foreign subsidiaries (Exhibits C & D). CCA'S vice-president of Latin American operations was also on the payroll of a South American subsidiary and had responsibility for all Latin American operations including 25 plants in 3 countries (CT 247), and it appears that a similar vice-president had similar authority over the European operations;

3. When dealing with bulky products such as containers and the materials they are made from, an efficient business would not transport raw materials or products large distances at large costs. (CT 254.) Instead it would allocate the world-wide market to its various branch operations, as CCA did. Some linerboard and unknown quantities of paper were provided to the foreign subsidiary by and through CCA

notwithstanding the high cost of transportation. (CT 254-255.) CCA made its used equipment available to its foreign subsidiaries. (CT 257.) (This was a simbiotic arrangement because the foreign subsidiaries had substantial use for lower-volume, less-automated equipment and provided a ready market when CCA wished to move into more advanced automated machinery.) (CT 209.) CCA purchased new equipment for its subsidiaries. (CT 158.)

In many cases charges by CCA were less than those which the subsidiaries would have had to pay to third parties. (E.g., CT 157, 158.) CCA'S separate accounting does not reflect the true benefits to the subsidiaries of this assistance by CCA;

4. The financial strength and expertise of CCA were at all times

available to and used by its subsidiaries when needed. The extent or benefit to the subsidiaries of the technical expertise and training is not shown in the evidence; nor is there evidence that CCA'S separate accounting made any attempt to (let alone did) reflect accurately the value of such services. Similarly, over half of the subsidiaries' financing came directly from or was guaranteed by CCA. (CT 250-251.) CCA did not establish what, if anything, subsidiaries paid it for this substantial and valuable financial assistance.

5. CCA has the burden of proof. It failed to prove that its contributions to its foreign subsidiaries (including financial, management skills, technical expertise, equipment and materials) were insubstantial. It failed to prove that its separate accounting

accurately reflects its contributions to its subsidiaries. (CCA inaccurately calls its "separate accounting " method an "arms length method" in its Jurisdictional Statement.)

CCA'S assumption in its statement of the issue presented that it is "not functionally integrated" is not established by the evidence and is contrary to the uniform determinations of the state courts that CCA'S foreign subsidiaries are a part of its unitary business. Similarly, CCA'S assumption in its statement of the issue that "misattribution of income to the parent results" and "the California method contradicts federal tax policy" have not been established by the evidence presented in this case and are simply incorrect.

CCA'S primary arguments before the state courts were that the evidence established that it was not engaged in a unitary business with its foreign subsidiaries. By far the largest part of the briefs, oral argument and courts' opinions dealt with this subject. CCA also tried to show that formula apportionment misallocated income by comparing income apportioned to California under unitary formula to income apportioned to California using its internal separate accounting methods in determining income from its foreign activities. Relying on this court's decision in Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434, CCA also argued that that case required that it be permitted to report California taxes based on its income as determined by its separate accounting methods. (At no time did CCA argue for

modification of the formula used; it argued solely for total rejection of the unitary formula approach and that it be permitted to report by separate accounting only.)

We believe the scope of the constitutional issues raised by CCA is shown by the Court of Appeal opinion appealed from. (Appendix A to the Petition.)

NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED: NO FURTHER ARGUMENT IS REQUIRED

A. Container Corporation's Foreign Subsidiaries are Part of Its Unitary Business

Only when a business is unitary does California apportion income by formula. (See Superior Oil Company v. Franchise Tax Board (1961) 60 Cal.2d 406.) This Court recognizes that the unitary principle is the "linchpin" of apportionability. (Mobil Oil Co. v. Vermont (1980) 445 U.S. 425, 439.) CCA concedes that it is a unitary business, but asks this Court to re-examine the factual determination by the California courts that its foreign operations (conducted through subsidiaries) are part of its unitary business. (Jurisdictional Statement pp. 21-23.) This court should not do so.

The California courts applied the test of unity established in Butler Bros. v. McColgan (1941) 17 Cal.2d 664; affd. 315 U.S. 501, and Edison California Stores v. McColgan (1947) 60 Cal.2d 406, 412), which have been uniformly applied in California for forty years (the three unities test and dependence -- contribution test). This Court has approved and followed those tests both in the Butler Bros. case itself (315 U.S. 501) and in more recent cases. In Mobil Oil Co. v. Vermont (1980) 445 U.S. 425, this Court cited Butler Bros. with approval (p. 438) and further stated that in order to avoid apportionability the taxpayer must show income is from an "unrelated activity" or a "discrete business" (p. 439), and that no apportionment would be made where the out-of-state activities

have nothing to do with the business activities within the state. (Mobil Oil Co. v. Vermont, supra, 445 U.S. at p. 442.)

No case has been cited by CCA nor found by the undersigned in which this Court undertook to review the evidence and reversed a state court finding that an enterprise was unitary. This Court should not reexamine the evidence or reweigh the factual determinations of the lower courts that CCA's foreign subsidiaries are part of its unitary business. (See Grayson v. Harris (1924) 267 U.S. 352, 358.)

Both California and this Court place the burden upon the taxpayer to prove that any activities which it asserts should be excluded from its unitary business are a distinct independent and discrete business. A cursory review of CCA'S activities shows that they are

1. All foreign subsidiaries are wholly or mostly owned by CCA. They are therefore subject to any and all controls and directions CCA should choose to impose.

2. CCA and subsidiaries engage in the same business (paperboard and packaging). CCA divided the market among the various units which do not compete with each other. The foreign units are treated the same as the United States units (which are conceded a part of the unitary business) in delegating responsibility to local management. Much of the "local" management of the foreign subsidiaries was performed by about 30 Americans transferred from CCA and/or on CCA'S payroll. The foreign operations were the responsibility of two officers which were on both CCA and subsidiary payrolls. Major decisions (defined by

CCA as capital transactions) for the subsidiaries had to be approved by CCA.

3. The initial foreign operations, (e.g., those in Colombia) were spawned and conducted by CCA personnel until CCA developed local expertise. The activities of several separate subsidiaries sidiaries within a single country were integrated by CCA to work closely together as a unit within the country of their operation. CCA'S technical expertise, training programs and technical materials were available to and made use of by the foreign subsidiaries. In a joint venture, CCA and a Colombian subsidiary developed a pulping process which would allow CCA'S Latin American subsidiaries to use locally available hardwoods. CCA procured or directly provided much of the technical equipment used by subsidiaries, especially in Latin American.

4. CCA'S financial strength supported the subsidiaries funding needs. Over 50% of the foreign subsidiary borrowing was directly from or guaranteed by CCA.

5. CCA provided to the subsidiaries raw materials which it purchased itself or procured from other persons. The amounts of paper so provided are unknown. CCA has not established that such amounts were not a substantial benefit to the subsidiaries.

6. CCA referred customers to its subsidiaries, (including a user of banana boxes which comprise a substantial portion of Latin American subsidiary products.)

7. While CCA calls its separate accounting method "arms length" CCA has not provided evidence establishing that its separate accounting methods

account for the substantial benefits provided by CCA to its foreign subsidiaries. The evidence does show that CCA transferred its used machinery at depreciated "book value" and procured items for subsidiaries at charges lower than independent brokers would have charged. Also some expertise was paid for simply by allocation of overhead costs. There is no suggestion that any payment was made in consideration of CCA guaranteeing loans; and presumably CCA would not have loaned money to the subsidiaries had outside money been available at the same price. The evidence does not show that many of the management and technical services and assistance provided were even paid for, let alone at an arms length price.

B. Formula Apportionment is Proper for International as Well as Interstate Unitary Enterprises

In arguing that the extension of unitary apportionment misattributes foreign source income (Jurisdictional Statement pp. 15-21) CCA states that the "extension of the three-factor formula beyond the borders of the United States produces an unreasonable result." (Jurisdictional Statement p. 17.)[1/] CCA tries to distinguish this Court's Bass and Mobil Oil cases. It cannot. Those cases control.

The Bass, Etc., Ltd. v. Tax Com. (1924) 266 U.S. 271, case clearly held that an international company was subject to formula apportionment where engaged in a unitary enterprise.

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1. This also appears to be the main thrust of a proposed of Amicus Curiae brief (which also misstates the facts and law, and should not be filed).

CCA asserts Bass is inapplicable because Bass did business through divisions rather than subsidiaries. In 1980 this Court reaffirmed the Bass case in Mobil Oil Co. v. Vermont, supra, 445 U.S. 525, which involved an American company doing business outside the United States through subsidiaries, just as CCA does. In Mobil this Court observed that the unitary principle is the "linchpin" of apportionability (at page 439) and stated that the Court must look through the nature of income taxed by the state (there dividends) to the underlying activity to determine the propriety of apportionability. (At page 440.) Thus this Court in Mobil looked at the unitary relations among Mobil and its foreign subsidiaries to determine that formula apportionment was proper.

FTB submits that this Court has clearly determined in Mobil that a formula may be used to apportion income of American corporations engaged in a unitary enterprise through foreign subsidiaries, such as CCA.

C. Where a Business is Unitary, Analyses Based on Separate Accounting Principles do not Preclude Formula Apportionment.

CCA suggests that as applied to the facts here formula apportionment is inaccurate and unfair and that "distortion is apparent from the record in this case" (Jurisdictional Statement pp. 16,17). What CCA does thereafter, however, is to rephrase the same old arguments rejected many times before that the formula is distorted because it gives different results from separate accounting. It refers to wage rates and a concept of 'return on investment" used

by some American companies in determining where to expand operations. These arguments totally ignore the basic concept of the unitary approach that separate accounting is not designed to, and does not accurately apportion income of a unitary enterprise among the various jurisdictions where business is done.[2/]

CCA has not contended that another formula or variations in the standard three-factor formula were needed to avoid its claim of distortion. It simply argues that apportionment must be totally abandoned and separate accounting must be used. This Court has clearly

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2. CCA lumps all foreign activities together in its arguments. Its figures which it presents to the Court (Jurisdictional Statement p. 11) show that in three of the seven foreign countries where CCA has operating subsidiaries formula apportionment shows greater income than CCA'S separate accounting, while in four it shows less. (See Jurisdictional Statement p. 11.)

ruled that separate accounting may not be demanded by a taxpayer and a state may require formula apportionment where, as here, the taxpayer engages in a unitary business. (Mobil Oil Co. v. Vermont (1980) 445 U.S. 425; Exxon Corp. v. Department of Revenue of Wisconsin (1980) 447 U.S. 207.)

D. The Japan Line Case Does Not Require Use of Separate Accounting

CCA argues that the Japan Line case requires a separate accounting here (Jurisdictional Statement pp. 8-15). In Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434 this Court discussed (among other things) enhanced risk of multiple taxation and impairment of a federal policy of tax uniformity. That case held impermissible a property tax in the United States on "instrumentalities of foreign commerce" (shipping

containers) which belonged to a Japanese company, were taxed on their full value in Japan, and were in the United States only as necessary for use in shipping goods in foreign commerce. This Court determined that because of a federal policy that foreign owned instrumentalities moving in foreign commerce be subjected to a property tax on their full value in their domiciliary country and the imposition of another property tax by a jurisdiction through which the instrumentality was travelling would in fact impose a double property tax, the second tax could not be imposed. These Japan Line principles were fully discussed and rejected as applied to use of an apportionment formula to determine taxable income of a United States corporation, such as CCA, engaged in a unitary business throughout the United States and in

foreign countries in the subsequent Mobil case.

This Court has recognized that the total income of a unitary business is a single unit which must be apportioned in some manner for the purposes of taxing income by states where a portion of the business occurs. Only a rough approximation is possible and required. (International Harvester Co. v. Evatt (1947) 329 U.S. 416, 422.) In Mobil, when discussing tax measured by income of a unitary business, this Court observed that profitability arises from the operation of the unitary business as a whole, then stated that it is "misleading to characterize the income of the business as having a single identified 'source.' Although separate geographical accounting may be useful for internal auditing, for the purposes of state taxation it is not

constitutionally required." (Mobil, supra, 445 U.S. 438.) In Japan Line (441 U.S. 455) this Court stated that it was not there dealing with imprecision in apportionment but a situation "where true apportionment does not exist. . . ." It is thus clear that the income taxation of unitary business requires apportionment while the property taxation under consideration in Japan Line precluded apportionment. The reasoning and analysis is Japan Line is therefore totally inapplicable here.

1. No federal "one voice" policy precludes formula apportionment of income:

This Court in the Mobil case directly rejected the contention that there is federal policy requiring that only separate accounting be used to determine how much of the income of an international unitary business is

apportionable to a state (445 U.S. 448-449).[3/]

2. There is no unconstitutional double taxation:

The impossibility of exactly allocating income of a multi-jurisdictional unitary business has been recognized a number of times by this Court, most recently reiterated in Mobil and Exxon cases. The proper constitutional test for adequacy of an apportionment formula is whether it

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3. Much of the support which CCA cites was contained in arguments and materials prepared by proponents of a United Kingdom treaty provision which was rejected by Congress. Little if any of this was introduced into evidence in this case and accordingly is not a proper part of the record and is inadmissible hearsay insofar as the truth of the statements made outside the courtroom are concerned. Even the rejected United Kingdom treaty provision would have permitted the formula apportionment here in issue. IRS appears to use formula apportionment methods in applying the federal income tax law to foreign operations. (See 89 Harvard L.R. 1202 at 1211-1212, 1222-1223.)

taxes income "out of all appropriate proportion to the business transacted" in the taxing jurisdiction. (425 U.S. 437.) CCA has offered no evidence suggesting that the seven to eight percent of its unitary income apportioned to California by the three-factor formula is out of all appropriate proportion to CCA'S business here. On the contrary, CCA'S own separate accounting methods apportion six to seven percent of such income to California. This miniscule difference strongly refutes any claimed constitutional invalidity.

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There is no absolute uniformity among income tax laws.[4/] Thus, there is always the potential for under-taxation or over-taxation of a multi-jurisdictional business, even were every jurisdiction to

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4. Income tax statutes of different states and countries indicate that even where based on separate accounting principles the method of measuring the net taxable income would have some differences in each jurisdiction. There seem to be numerous differences in what are considered business income and expenses, and deductions allowed for depreciation and depletion. Statutory differences would seem to be multiplied when individual administration and determinations as to "reasonable" amounts (particularly allowable as business deductions) enter into the calculations of taxable net income.

Even the Uniform Division of Income for Tax Purposes Act (UDITPA) used by California (which has been adopted by a number of states and appears to be one of the most uniform methods of apportionment) has some variations among the jurisdictions. It is believed that there is no reasonable possibility of insuring that 100 per cent and only 100 per cent of the income of a unitary business operating in several taxing jurisdictions is included in tax measures.

apportion income based on separate accounting principles. It should be further noted that multiple taxation of the same income at various governmental levels is clearly permitted. (E.g., the United States and California each tax all the income of corporations doing business there.) We know of no case holding that the United States could not tax income of an American corporation because a foreign country could tax or had already taxed the same income. The power of this Court over and the constitutional considerations applicable to the taxation of income of American corporations like CCA who are engaging in unitary businesses throughout the world are entirely different from those before the Court in Japan Line.

Even were Japan Line applicable, this Court specifically limited its ruling there to a situation where

actual double taxation was clearly established by the evidence. It stated " . . . we have no occasion here to decide under what circumstances the mere risk of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate commerce." (441 U.S. 452, fn. 17.) CCA has not established by admissible evidence that its payment of any income taxes in any foreign countries (at either state or federal level) has resulted in double taxation of the same income.5/

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5. CCA introduced no evidence that any other state level jurisdiction has imposed income tax on its foreign subsidiaries.

Further, CCA's own figures show that no more than 33 percent of its unitary income came from foreign sales, and thus could have been subjected to the

(continued)

It should be clear from the foregoing that neither the Japan Line case, nor the (nonexistent) "federal

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Footnote 5 cont:

income tax it paid to foreign countries. California taxed only seven to eight percent of CCA'S unitary income (the percentages differed slightly in different years) by CCA'S own figures (Jurisdictional Statement p. 11). Thus about 60 percent of CCA's world wide income apparently has escaped both California and any foreign income tax. (It should be noted that the function of California's three-factor formula is to allocate a percentage of world-wide income to California. It has no function of determining how the remaining (here 92-93%) unitary income should be apportioned among the rest of the world. It is not proper, as CCA does to say that California apportions any percentage of income to any other jurisdiction.)

Also, American corporations doing business abroad receive a credit against federal income tax for certain income taxes paid in foreign countries. All such credits should be considered in determining if and to what extent there was double taxation of the same income. (Where the United States has given income tax credit for the foreign tax the tax burden appears no different than if only the United States and the state imposed an income tax.)

uniformity" nor the (unproven) "double taxation" forms a substantial basis for this Court's reviewing or reversing the lower court decision here.

CONCLUSION

CCA almost totally ignores the unitary concept so clearly enunciated by this Court most recently in the Mobil and Exxon cases. Income of a multi-jurisdictional unitary business is properly apportioned through a formulary method. This rule is equally applicable to a United States corporation which operates outside the United States and through subsidiaries. The normal, most commonly accepted and used formula is the three-factor formula used by California here, embodied in UDITPA, and used by a large number of other states.

CCA has failed to establish by admissible evidence that any (let alone

all) of its foreign subsidiaries are not a part of its unitary paperboard and packaging enterprise. A cursory review of the evidence, we feel, makes unity clear.

CCA'S attempt to show distortion consists primarily of comparision between formula apportionment and the separate accounting approach which ignores the substantial contributions by CCA to the profitability of the foreign subsidiary operations. Contrary to CCA'S assertions, these substantial contributions are not accounted for by CCA'S separate accounting. The miniscule (one to two percent) difference (between formula and separate accounting) in the amount of world-wide income apportioned to California and lack of contrary evidence clearly show that CCA has totally failed to prove that the income apportioned to California under the UDITPA

formula is "out of all appropriate proportion to the business transacted" in California. CCA has not suggested any modifications in or alternative formulas to the UDITPA formula used by California here. CCA insists only that separate accounting must be used.

This Court's discussion of the Japan Line case in its subsequent Mobil case shows that CCA'S reliance on Japan Line is misplaced. As this Court observed in Mobil, notwithstanding substantial consideration by Congress, this country has not adopted a policy precluding international formula apportionment. CCA relies heavily upon various statements of people who have lobbied against formulary apportionment but introduced no substantial admissible evidence supporting its criticism of the unitary principle. Even the United

Kingdom treaty provision in support of which much of the matter relied upon by CCA was offered (but which was rejected by Congress) would not in any way have impeded applying the formula apportionment approach to American corporations doing unitary business abroad through foreign subsidiaries, such as CCA.

The problem of double taxation of the same income at the same governmental level (and its converse problem of escape of income from any taxation) is difficult if not insoluble. This Court has recognized that in dealing with unitary businesses exact allocation is impossible and rough approximation is necessary. CCA has not established any state level taxation by any foreign jurisdiction. Nor has CCA shown that California's income tax, plus all foreign taxes resulted in more than 100 percent

of its income being taxed, or any unconstitutional burden on it.

In sum, the recent determinations of this Court in the Mobil and Exxon cases clearly support the decision of the courts below; CCA has not established by admissible evidence any factual basis supporting its implied assertion that its international business is not unitary or that it has been deprived of any constitutional rights under due process or the commerce clause.

This Court should either dismiss this action for want of a substantial federal question, or affirm the lower court's decision on the basis of this motion and without hearing on the grounds that the questions have been heretofore resolved by this Court and are so unsubstantial as to not need further argument. Constitutional issues beyond

those discussed above and heretofore resolved against CCA by this Court were not properly raised. The judgment rests on adequate non-federal basis because of CCA'S failure to prove that it was not a unitary business or facts showing deprivation of constitutional rights under the due process or the commerce clause.

Respectfully submited,

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SUPREME COURT OF THE UNITED STATES

No. 81-523, October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

CERTIFICATE OF SERVICE

I, Neal J. Gobar, one of the attorneys for the Franchise Tax Board, appellee herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 13th day of October, 1981, I served copies of the foregoing Motion of Appellee to Dismiss or Affirm on several parties thereto, as follows:

On the Container Corporation of America, appellant, by mailing three copies in a duly addressed envelope, with first-class postage prepaid, to its attorneys of record, as follows:

Franklin C. Latcham
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It is further certified that all parties required to be served have been served in accordance with Supreme Court Rule 28.

NEAL J. GOBAR
Deputy Attorney General

Attorneys for Appellee
Franchise Tax Board

Office-Supreme Court, U
FILED
OCT 23 1981
ALEXANDER L. STEVAS
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No. 81-523

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court of Appeal of the State of California for the First Appellate District

BRIEF IN OPPOSITION TO MOTION TO DISMISS OR AFFIRM

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TABLE OF CONTENTS

Page

I

Probable jurisdiction should be noted in view of the *Asarco* and *Woolworth* cases 1

II

Reply to FTB motion to dismiss or affirm 2

Conclusion 5

TABLE OF AUTHORITIES

Cases

American Smelting & Refining Co. v. Idaho State Tax Commission, 99 Idaho 924, 592 P.2d 39 (1979), vacated and remanded sub nom. Asarco Inc. v. Idaho State Tax Commission, 445 U.S. 939 (1980), per curiam on remand, 102 Idaho 38, 624 P.2d 946 (1981), prob. juris. noted, No. 80-2015 (U.S. Sup. Ct. October 5, 1981) 1, 2

F. W. Woolworth Co. v. Taxation and Revenue Department, 95 N.M. 519, 624 P.2d 28 (1981) prob. juris. noted, No. 80-1745 (U.S. Sup. Ct. October 5, 1981) 1, 2

Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980) 1, 4

Statutes

Uniform Division of Income for Tax Purposes Act (U.L.A.) § 18 4

Cal. Rev. & Tax Code § 25137 (Deering) 4

BRIEF IN OPPOSITION TO MOTION TO DISMISS OR AFFIRM

I

PROBABLE JURISDICTION SHOULD BE NOTED IN VIEW OF THE ASARCO AND WOOLWORTH CASES

Subsequent to appellant filing its Jurisdictional Statement, the Court noted probable jurisdiction in the *Asarco* and *Woolworth* cases.[1] These cases are concerned, *inter alia*, with different aspects of the issue raised in *Mobil Oil Co. v. Vermont*, 445 U.S. 425 (1980), *i.e.*, the taxation of dividend income from subsidiaries and affiliates. In the *Woolworth* case the dividends are all from foreign subsidiaries; in the *Asarco* case a substantial part of the dividends are from foreign subsidiaries.

In view of the fact that the Court has noted probable jurisdiction in the *Asarco* and *Woolworth* cases, appellant submits that the Court should note probable jurisdiction in the instant case. By so doing, the Court can finally resolve whether there are constitutional limitations on the states' ability to include *all* of the income of foreign affiliates and subsidiaries in the tax base of a United States corporation through worldwide unitary combination. The issue presented in the instant case, inclusion of total earnings of

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[1] *American Smelting & Refining Co. v. Idaho State Tax Commission*, 99 Idaho 924, 592 P.2d 39 (1979), *vacated and remanded sub. nom. Asarco Inc. v. Idaho State Tax Commission*, 445 U.S. 939 (1980), *per curiam on remand*, 102 Idaho 38, 624 P.2d 946 (1981), *prob. juris. noted*, No. 80-2015 (U.S. Sup. Ct. October 5, 1981) and *F. W. Woolworth Co. v. Taxation and Revenue Department*, 95 N.M. 519, 624 P.2d 28 (1981) *prob. juris. noted*, No. 80-1745 (U.S. Sup. Ct. October 5, 1981).

foreign affiliates and subsidiaries, is related to but broader than the issue presented in *Asarco* and *Woolworth, i.e.*, inclusion of foreign source dividends.[2] Thus, if this Court only decides the issues raised in *Asarco* and *Woolworth*, significant issues relating to state taxation of foreign source income will remain unresolved.

The brief *amicus curiae* filed by the Committee on State Taxation of the Council of State Chambers of Commerce states that there are a large number of cases pending at the judicial and administrative levels involving the combined reporting issue. By accepting this case, the Court can resolve important constitutional questions involving combined reporting which should substantially reduce pending litigation in this area.

II

REPLY TO FTB MOTION TO DISMISS OR AFFIRM

The Franchise Tax Board ("FTB") asserts that "the specific question sought to be reviewed in the jurisdictional statement was not properly raised in the state courts from which an appeal is taken." Motion of Appellee to Dismiss or Affirm ("Motion") at 2, 40. The FTB makes no effort whatsoever to substantiate this assertion as indeed it cannot. Container raised the constitutional issues in its claims for refund to the FTB, in its complaint, C.T. 8-9, 10, 13, 24-25,

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[2]In the *Asarco* case, six of the subsidiaries (some apparently foreign subsidiaries) were required by the state to be included in a combined report with the parent. The dividends from these subsidiaries were not taxed. *Asarco* did not raise the combination issue in its state court appeal (592 P.2d 39, 43, 45) nor in its Jurisdictional Statement filed with this Court.

60-71, 92-93, 114-116, and in its briefs to the courts below. Both the Superior Court and the Court of Appeal specifically rejected the constitutional claims. App. A, Jurisdictional Statement, A-17 to A-26; App. B, Jurisdictional Statement, A-31.

The FTB also alleges that Container recited the facts inaccurately. Motion at 6 et seq. and 17 et seq. Container believes that its statement of facts is accurate and that many of the factual assertions made by the FTB are inaccurate. In any event, the facts are undisputed since they were presented entirely through a written stipulation, plus the uncontroverted testimony of a single expert witness. That part of the record including the stipulation of facts and testimony has been received by the Court.

The FTB states that Container did not argue for a modification of the formula before the lower courts. Motion at 12, 13, 37. On the contrary, Container did ask for a modification; it has consistently sought the use of arm's-length/separate accounting for apportioning income as between Container and the foreign subsidiaries while agreeing to formulary apportionment as to the domestic operations of Container itself.[3] Separate accounting has long been recognized as an alternative to formulary appor-

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[3]Appellant has consistently used the phrase arm's-length method in the same way as the FTB has used the phrase separate accounting. Appellant has used the phrase arm's-length because that is the term most often used by the federal government in describing the federal method of apportioning income as between United States corporations and foreign affiliates.

tionment.[4] In addition, if the federal government is to speak with one voice in the area of foreign commerce, the arm's-length/separate accounting method is the only permissible apportionment method in this case since it is the system adopted by the United States in apportioning income as between United States corporations and foreign affiliates.

It is also important to note that the FTB devotes only a single sentence to the point that world-wide unitary combination clearly conflicts with and impairs the arm's-length method adopted by the United States for apportioning income between United States and foreign affiliated corporations. The FTB's only attempt to answer this vital point is a citation to the *Mobil* case. Motion at 28, 29. Of course, *Mobil* involved only the question of the proper apportionment, as between the states, of dividends received by a United States corporation. It did not involve an apportionment of income as between the states and foreign countries.

Finally, the FTB argues that it is only apportioning to California seven to eight percent of the world-wide income of Container and its foreign subsidiaries. The facts are, however, that for the three years involved, world-wide unitary combination apportioned to California income totalling over $1,200,000 in excess of that determined by the arm's-length federal method. Exhibit A to Stipulation of Facts.

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[4]It is specifically recognized as an alternative in the Uniform Division of Income for Tax Purposes Act, which California and 23 other states have adopted. 7A U.L.A. (1980 P.P.) at 7. See Section 18 of the Uniform Act and Section 25137, Cal. Rev. & Tax. Code (Deering).

Furthermore, the Court's decision in this case will not be limited to California. If California can apportion additional income to the state through world-wide unitary combination, every other state can follow California's example and achieve a similar result.

CONCLUSION

The motion to dismiss or affirm should be denied and probable jurisdiction should be noted.

Dated: October 21, 1981

Respectfully submitted,

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APR 30 PAGE 9

No. 81-523

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

OPPOSITION OF APPELLEE TO SECOND MOTION OF APPELLANT TO EXPEDITE NOTING OF PROBABLE JURISDICTION

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No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

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FRANCHISE TAX BOARD,

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FIRST APPELLATE DISTRICT

OPPOSITION OF APPELLEE TO SECOND
MOTION OF APPELLANT TO EXPEDITE
NOTING OF PROBABLE JURISDICTION

* * * * *

In November 1981, this Court considered and denied appellant's motion to note probable jurisdiction. On April 28, 1982, a second motion was received by appellee and we were advised that any opposition must be filed by April 28. Time permits only summary response.

Appellee strongly opposes any delay in deciding the constitutional issues raised by Chicago Bridge & Iron (CBI) (in No. 81-349). CBI (see Brief of Appellant, Questions Presented, p. i) raises important straightforward legal constitutional

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issues[1] which are being argued by multi-national unitary businesses in numerous cases now in lower courts.

Clear and prompt resolution of these questions will save endless hours of time and huge attorney costs in many pending cases. The Chicago Bridge decision should not be delayed, but should be issued prior to the summer recess if at all possible.

This Court should clearly and speedily rule in the CBI case that use by states of formula apportionment to determine taxable income of unitary international businesses, (1) does not prevent the federal government from speaking with one voice, in violation of the commerce clause, (2) nor does creation of a substantial risk of double taxation violate the commerce clause, (3) nor does the normal three-factor formula violate due process or equal protection requirements.

Probable jurisdiction in this case should not be noted. Throughout this case, appellant Container Corporation of America (CCA) has primarily argued that it is not unitary (under its version of the evidence). The record contains controverted contradictory, disputed evidence. The courts have rejected CCA's version of the evidence and refused to find the

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1. Various Amici have attempted to state and argue questions different from those raised by appellant CBI, and to present their own "hypothetical" facts. Those aberrations should not either be allowed to side-track prompt and clear resolution of the clear legal issues raised by CBI's frontal attack on any use of formula apportionment by international multi-corporate unitary businesses.

unconstitutional "double taxation" which CCA incorrectly states "actually exists." The record here is not one on which general constitutional rules should be created as guides for use generally.

Our "Opposition" to Appellant's first motion, filed November 18, 1981, specifically, and the Motion to Dismiss or Affirm, filed about October 1, 1981, in general, should be referred to for additional reasons why probable jurisdiction should not be noted (and they are incorporated by this reference).

Respectfully submitted,

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No. 81-523

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ON APPEAL FROM THE SUPREME COURT
OF THE STATE OF CALIFORNIA

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

and

BRIEF AS AMICI CURIAE IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

MOTION FOR LEAVE TO FILE BRIEF AS *AMICI CURIAE*

Canadian Imperial Bank of Commerce, Hiram Walker Resources Limited, Inco Limited, MacMillan Bloedel Limited, Northern Telecom Limited, and Wawanesa Mutual Insurance Company hereby respectfully move for leave to file their brief as *amici curiae*. Consent of the attorney for the Appellant has been obtained. Consent of the attorney for the Appellee has been denied.

Your *amici* are incorporated under the laws of Canada, and conduct extensive business operations, either directly or through subsidiary corporations, in Canada, in other countries, and in the State of California.

In 1980, your *amici* had gross assets of approximately 69 billion Canadian dollars and total revenues of approximately 17 billion Canadian dollars. Your *amici* control aproximately 270 significant subsidiaries throughout the world.

Each *amicus* is a substantial representative of the industry in which it operates. Canadian Imperial Bank of Commerce is the second largest bank in Canada. Hiram Walker Resources Limited is the second largest Canadian distillery and a producer and distributor of natural gas and petroleum. Inco Limited is the free world's largest producer of nickel. MacMillan Bloedel Limited is the largest forest products company in Canada. Northern Telecom Limited is the largest telecommunications equipment supplier in Canada, and the second largest in North America. Wawanesa Mutual Insurance Company is the tenth largest casualty insurance company in Canada.

The California unitary tax has world-wide trade and investment ramifications, including adverse effects on your *amici*. The issues presented are critical to every foreign corporation doing business either in California or in any other state that applies a similar unitary method of apportionment of income derived from foreign commerce. That method of apportionment conflicts with uniform Federal policy governing the allocation of income between the United States and foreign countries. The international political, trade, and commercial consequences attendant upon California's *international* application of the unitary method of apportionment require this Court's examination of the extent to which Federal powers, Federal law, and international treaties and customs constitutionally preclude California from using its method of apportionment in a global context which conflicts with Federal policy.

In supporting the Appellant, your *amici* request that this Court restore the supremacy and uniform voice of the Federal government in the conduct of foreign relations and thereby effect an improvement in the international investment climate and minimize possible retaliatory trade actions.

Under the United States Constitution, your *amici*, other international enterprises, and sovereign nations cannot resolve their income apportionment disputes with California or with any other state either by treaty or by litigation in an international forum. Only a Federal solution is Constitutional.

Your *amici* therefore respectfully request permission to present to this Court their perspective as international companies whose substantial investment in, and trade with, the United States is particularly vulnerable to action by individual states, which action results in double taxation and impedes the free flow of international investment and trade.

Respectfully submitted,

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ON APPEAL FROM THE SUPREME COURT
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BRIEF AS *AMICI CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

TABLE OF CONTENTS

QUESTIONS PRESENTED 1

INTEREST OF THE *AMICI CURIAE* 2

SUMMARY OF ARGUMENT 3

ARGUMENT:

I.

Pervasive Federal Control Of Allocation Of Taxable Income Between The United States And Foreign Nations Pre-empts State Regulation Of International Allocation Of Taxable Income 5

II.

The International Application Of California's Unitary Method Of Apportionment Of Taxable Income Infringes Upon The Conduct Of Foreign Relations, Which Is An Area Of Exclusive Federal Authority 9

III.

California's Unitary Method Of Income Apportionment, Applied Internationally, Inevitably Results In Double Taxation And Impermissible Burdens On International Commerce In Violation Of The Due Process And Commerce Clauses Of The Constitution 12

CONCLUSION 18

TABLE OF AUTHORITIES

CASES:

Campbell v. Hussey, 368 U.S. 297 (1961) 5
Chy Lung v. Freeman, 92 U.S. 550 (1876) 11
Henderson v. Mayor of New York, 92 U.S. 543 (1876) 12
Hines v. Davidowitz, 312 U.S. 52 (1941) 5, 8, 11
Hoeper v. Tax Commission of Wisconsin, 284 U.S. 206 (1931) 15
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 4, 7, 8, 11, 12, 13, 14
Michelin Tire Corporation v. Wages, 423 U.S. 276 (1976) 8, 12
Washington Revenue Department v. Association of Washington Stevedoring Cos., 435 U.S. 734 (1978) 12
Zschernig v. Miller, 389 U.S. 429 (1968) 9, 11

CONSTITUTIONAL PROVISIONS AND TREATIES:

U.S. CONST. art. I, § 8, cl. 3 ..... 4, 13, 15
U.S. CONST. amend. XIV, § 1 4
U.S. CONST. art. VI, cl. 2 ..... 4, 5
5 U.S.T. 2768, T.I.A.S. No. 3133; 16 U.S.T. 1865, T.I.A.S. No. 5920 6
56 STAT. 1399, T.S. 983 7
I.R.C. § 482 6
Press Release By British Information Department, Hearings On H.R. 5076 Before The House Comm. On Ways And Means, 96th Cong., 2d Sess. 317 (1980) 11
State Taxation Of Foreign Source Income: Hearings On H.R. 5076 Before The House Comm. On Ways And Means, 96th Cong., 2d Sess. 360 (1980) 10

State Taxation Of Foreign Source Income: Hearings On H.R. 5076 Before The House Comm. On Ways And Means, 96th Cong., 2d Sess. 317 (1980) 11

State Taxation Of Interstate Commerce And Worldwide Corporate Income: Hearings On S. 983 Before The Sub-Comm. On Taxation And Debt Management Generally Of The Senate Comm. On Finance, 96th Cong., 2d Sess. 75 (1980) 10

TREAS. REG. § 1.482-1(a) 9

TREAS. REG. § 1.482-2(c) 17

QUESTIONS PRESENTED

Whether allocation of income for tax purposes between the United States and foreign nations has been pre-empted by the Federal government so that the international application of the California formula violates the Supremacy Clause;

Whether application of the California formula internationally interferes with accepted international and Federal practice, thus preventing a uniform Federal policy in the area of international taxation of income, disrupting foreign trade relations, and thereby violating the Commerce Clause; and

Whether application of the California formula to income derived by a foreign-controlled unitary group produces a substantial risk of international multiple taxation in violation of both the Commerce Clause and the Due Process Clause.

INTEREST OF THE *AMICI CURIAE*

Your *amici* are among the largest corporations in the world and are leading companies in their own industries and in Canada. All conduct the major part of their business activities outside the United States, but have significant business interests in the United States, usually through American subsidiaries. All are California taxpayers.

Foreign multi-national corporations wishing to do business in the United States face greater problems with the international application of California's unitary method of apportionment than do domestic corporations.

The interest of your *amici* in this case arises from the arbitrary results of the international application of California's unitary method of apportionment. This method includes in the apportionment formula the sales, property, and payroll of a foreign parent company, as well as most, if not all, of its foreign subsidiaries, none of which conducts business in California. The result in many instances is that California imposes its income tax on an apportioned amount of income far in excess of the actual economic gain derived in California, and, in some instances, in excess of the actual economic gain derived from all business conducted in the United States.

A decision to note probable jurisdiction would permit this Court to review the merits of the Constitutional issues and to prohibit the application of California's unitary method of income allocation internationally where it contradicts a clearly defined Federal policy to employ the "arm's length—independent entity" method in allocating income between the United States and foreign

nations. Such a result would limit the imposition of California income tax to a properly apportioned amount of income actually derived within the United States by your *amici*.

SUMMARY OF THE ARGUMENT

In exercising its exclusive control of foreign commerce, the Federal government has created an extensive network of international agreements that pre-empt state regulation of income allocation among nations. The Federal regulatory framework, expressed in over 40 income tax treaties with governments around the world, creates a comprehensive and coherent Federal policy of income allocation on an "arm's length—independent entity" basis that entirely pre-empts state apportionment of income between the United States and foreign nations on any inconsistent basis. The instant case thus also presents an important issue of Federal pre-emption under the Supremacy Clause of the Constitution.

California's unitary income apportionment scheme applied to foreign corporations constitutes state regulation of foreign commerce, in violation of the Constitution's exclusive grant of such authority to the Federal government. In regulating foreign commerce, California jeopardizes the ability of the Federal government to define and implement United States trade policy and interferes with the conduct of international relations. Such state regulation violates an exclusive Constitutional grant of power to regulate foreign commerce and ignores the justifications of that grant, articulated in this Court's

recent opinion in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

Additionally, the California system of apportioning income internationally abridges the Due Process Clause of the Constitution through arbitrary and substantial misallocation and double taxation of income.

The instant case presents, in a heretofore unconsidered international context, the unconstitutionality of such arbitrary misallocations as burdens on international commerce under the Commerce Clause, and a denial of due process.

Constitutionally, your *amici* and their government must rely upon Federal definitions of United States trade policy. The global application of the California system demonstrates state action compromising United States foreign relations. Your *amici* respectfully urge this Court to note probable jurisdiction and to reaffirm the Constitutional allocation of power to the Federal government, and to redress the unconstitutional effects of state regulation.

ARGUMENT

I.

PERVASIVE FEDERAL CONTROL OF ALLOCATION OF TAXABLE INCOME BETWEEN THE UNITED STATES AND FOREIGN NATIONS PRE-EMPTS STATE REGULATION OF INTERNATIONAL ALLOCATION OF TAXABLE INCOME.

Under the Supremacy Clause, Federal pre-emption of state regulation results from either a prevalent need for uniform Federal regulation or the existence of a pervasive scheme of Federal controls. Both criteria are met in the regulation of international allocation of taxable income and require this Court's review of California regulation of a federally pre-empted field.

When finding pre-emption as a result of a pervasive scheme of Federal controls, this Court has never required a direct conflict between express language of state and Federal regulations. *Campbell v. Hussey*, 368 U.S. 297 (1961). Particularly in foreign relations and other areas of exclusively Federal competence, Federal action can entirely pre-empt even those state regulations that appear on their face to be consistent with Federal action. *Hines v. Davidowitz*, 312 U.S. 52 (1941)

The United States maintains a pervasive scheme for the international allocation of income for tax purposes. The United States has entered into income tax treaties with approximately 40 foreign nations. These treaties create a detailed and sophisticated set of rules designed to allocate income between the United States and each treaty nation. Tax issues covered by the treaties include the circumstances under which an enterprise of one country becomes subject to taxation in another, agreed exemption of certain kinds of income from taxation,

allocation of income among related enterprises, and arrangements to prevent double taxation of the same income.

Income tax treaties are negotiated to avoid and resolve conflicts as to which nation shall tax income. Such treaties necessarily include rules allocating taxable income. These income tax treaties of the United States establish a uniform Federal policy under which taxable income is allocated between the United States and foreign countries according to the "arm's length—independent entity" principle.

Nearly all income tax treaties contain language to the following effect:

> Where an enterprise of one of the contracting States is engaged in trade or business in the other State through a permanent establishment situated therein, there shall be attributed to such permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.[1]

The United States Internal Revenue Service Office of International Operations, in common with similar foreign authorities, actively implements these and other tax treaty provisions, which are closely integrated with the Internal Revenue Code of the United States.[2] The

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[1] See Article III(2) of Income Tax Treaty between the United States and Germany, as amended by December 27, 1965, protocol. 5 U.S.T. 2768, T.I.A.S. No. 3133; 16 U.S.T. 1865, T.I.A.S No. 5920.

[2] See I.R.C. § 482 and Treas. Reg. § 1.482-1(a)(1):

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer,

(Footnote continued on following page)

treaties also provide for resolution of alleged double taxation by referring conflicts to the competent authorities of each contracting nation.

The need for international income tax treaties is well-illustrated by several industries. The income tax treaty between the United States and Canada recognizes the economic realities of international commerce involving the operation of ships and aircraft. Under the treaty, earnings derived from the operation of ships and aircraft in international traffic by enterprises registered in one country are exempt from tax in the other country on a reciprocal basis.[3] This provision thus allocates taxable income between the two countries according to an explicit Federal policy. *Cf. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (recognizing Federal policy regarding the susceptibility of instrumentalities of commerce to property taxation). The need for international agreement in allocating income in other industries is equally prevalent and is recognized by the treaties. Inconsistent state regulation is incompatible with this need. As is discussed later, California's unitary method of apportionment of income is clearly inconsistent with the Federal "arm's length—independent entity" policy.

The pervasive scheme of Federal control that has traditionally led this Court to find Federal pre-emption is readily apparent in the extensive network of inter-

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[2] *continued*
by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer.

[3] See Article VIII of the Tax Treaty between the United States and Canada dated March 4, 1942, 56 Stat. 1399, T.S. 983. The new treaty between the U.S. and Canada, now in the process of ratification, contains the same policy.

national income tax treaties. That network reveals a Federal policy to regulate, at the international level, the allocation of taxable income between the United States and any particular foreign nation, excluding inconsistent or supplementary state regulation of the same subject matter. As this Court stated in *Hines v. Davidowitz*, 312 U.S. 52, 62-63 (1941):

> When the national government by treaty or statute has established rules and regulations touching the rights, privileges, obligations or burdens of aliens as such, the treaty or statute is the supreme law of the land. No state can add to or take from the force and effect of such treaty or statute.

This Court found a uniform Federal policy in *Japan Line* after examining a far less extensive international regulatory framework than is applied to the international allocation of taxable income. Your *amici* respectfully suggest that the uniform adherence to the "arm's length—independent entity" method in more than 40 income tax treaties to which the United States has become a party reveals an even greater Federal policy of uniformity, which cannot tolerate the diverse and contradictory state regulations exemplified by the California decision.

Applying traditional pre-emption analysis, Federal pre-emption of state control of international taxable income allocation is justified by the prevalent need for a uniform international policy, as well as by the existing Federal controls. The need for a uniform policy and "speak[ing] with one voice" in international affairs has been recognized by this Court. *Michelin Tire Corporation v. Wages*, 423 U.S. 276, 289 (1976). California's unitary method of apportioning income on an international basis prevents this need from being met. This

issue of Constitutional supremacy of Federal over state regulation of international tax matters merits review by this Court.

II.

THE INTERNATIONAL APPLICATION OF CALIFORNIA'S UNITARY METHOD OF APPORTIONMENT OF TAXABLE INCOME INFRINGES UPON THE CONDUCT OF FOREIGN RELATIONS, WHICH IS AN AREA OF EXCLUSIVE FEDERAL AUTHORITY.

California regulation of taxable income allocation among nations has affected "international relations in a persistent and subtle way." *Zschernig v. Miller*, 389 U.S. 429, 440 (1968). State "regulations must give way if they impair the effective exercise of the Nation's foreign policy." *Id.*

Foreign sovereigns perceive the global application of state unitary apportionment schemes as unjustified attempts by individual states to extend their tax reach far beyond the territorial boundaries of the United States. As expressed by the Italian government, on its own behalf and on behalf of the nine EEC governments:

> Our Governments are concerned about the application to U.S. subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States. . . . This method is *incompatible with the principles accepted by all OECD member* [countries] and recommended to all [countries] as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the sub-

> sidiary and the related enterprises. (Emphasis added.)[4]

The same concerns were echoed by the British National Committee of the International Chamber of Commerce. Referring to the unitary apportionment of international income by California, the Committee's representative testified:

> Such actions by the States also *violate the treaties of friendship and commerce* which we have entered into in the United States with 25 foreign nations. This *fairly invites retaliation by foreign governments* against U.S. companies, with serious potential burdens on U.S. business overseas. (Emphasis added.)[5]

California's involvement in apportioning income internationally has significant effects on international relations. Tax policy, foreign trade, and foreign policy are all intimately related.

The British government has underscored the potential risks of continued California interference with a preexisting Federal policy that is the result of careful negotiation among the trading partners of the United States.

> Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework

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[4] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 360 (1980).

[5] State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 Before the Sub-Comm. on Taxation and Debt Management Generally of the Senate Comm. on Finance, 96th Cong., 2d Sess. 75 (1980). The same group has also concluded that the California system "creates major barriers to United Kingdom investment in the United States and to international trade between our two countries." *Id.*

> for business and investment, *for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development.* It is the view of Her Majesty's Government that *the unitary basis,* which is not a practical international alternative to the "arm's-length" basis, *could undo the important and patient international work that has been achieved in regulating international tax practices,* and that every effort is required to discourage the use or the extension of that basis. (Emphasis added.)[6]

Consistent with the Constitution, this Court has prohibited state regulation of issues that impact upon foreign relations. "Experience has shown that international controversies of the gravest moment, sometimes even leading to war, may arise from real or imagined wrongs to another's subjects inflicted, or permitted, by a government." *Hines v. Davidowitz,* 312 U.S. 52, 64 (1941). Policies risking foreign retaliation should be pursued only upon a *Federal* evaluation of the consequences and a Federal decision to proceed. *Chy Lung v. Freeman,* 92 U.S. 550 (1876). This Court's opinion in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), reiterated the Constitutional requirement of reserving to the United States all power over issues that might precipitate dramatic retaliation by foreign sovereigns acting on behalf of their commercial constituents. State regulation that potentially impacts upon foreign relations or jeopardizes the power of the Federal government to deal comprehensively with those problems must be invalidated. *Zschernig v. Miller,* 389 U.S. 429 (1968).

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[6] Press Release by British Information Department, Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 317 (1980).

In international relations, the political and the economic are inseparable; indeed, one is often the inducement for the other. The complicated interface of United States trade policy with foreign nations dictates exclusive Federal responsibility for diplomatically tailoring the regulation of foreign commerce in pursuit of United States foreign policy. *Henderson v. Mayor of New York*, 92 U.S. 543 (1876).

The United States must "speak with one voice," 423 U.S. at 285, and only the exclusive Federal control of foreign commerce can produce that result. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Michelin Tire Corporation v. Wages*, 423 U.S. 276 (1976); *Washington Revenue Department v. Association of Washington Stevedoring Cos.*, 435 U.S. 734 (1978).

Your *amici* respectfully request this Court to note probable jurisdiction and review the California decision in this case.

III.

CALIFORNIA'S UNITARY METHOD OF INCOME APPORTIONMENT, APPLIED INTERNATIONALLY, INEVITABLY RESULTS IN DOUBLE TAXATION AND IMPERMISSIBLE BURDENS ON INTERNATIONAL COMMERCE IN VIOLATION OF THE DUE PROCESS AND COMMERCE CLAUSES OF THE CONSTITUTION.

Application of the California unitary method of apportionment leads to taxation of more than the actual economic gain of a unitary group in any instance where profitability[7] is higher outside the United States than inside the United States. In such circumstances, the uni-

[7] Ascertained under the "arm's length—independent entity" method and expressed as a percentage of sales, property, and payroll.

tary method of apportionment has the effect of shifting taxable income into the United States.[8] However, foreign countries do not decrease income taxable in their countries merely because a state of the United States has used the unitary method of apportionment to increase its share of taxable income. The inevitable result is double taxation of the amount of income shifted into the United States.

In *Japan Line*, this Court observed:

> In addition to answering the nexus, apportionment, and nondiscrimination questions posed in Complete Auto, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a State tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. at 451.

Your *amici* submit that the application of the California unitary method of apportionment in the international context inevitably falls within the language quoted above. Taxing "more than one full value," *Id.* at 448, is no less repugnant to the Commerce Clause when the

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[8] This situation can be mathematically illustrated by assuming a Canadian company that has a wholly owned California subsidiary engaged in business only in California. Assume further that true economic gain of the combined group is $100 and under the independent entity arm's length approach, $90 is earned in Canada and $10 in California but that 20% on average of combined sales, property, and payroll is in California. In such circumstances, income subjected to tax in Canada would be $90 and income subjected to tax in California would be $20 for a combined taxable income of $110.

subject matter of the tax is total income than when it is tangible personal property as in *Japan Line.*

In many instances, the international operation of California's unitary method of income apportionment will result in substantially higher tax burdens for subsidiaries of foreign corporations than for their domestically owned competitors. This result denies due process.

As an example, assume two domestically owned independent manufacturers with identical California operations. If one of them is purchased by a more profitable foreign corporation with no other operations in the United States, and operations of the purchased California company remain the same, it will be burdened with higher taxes than its California competitor. The additional taxes paid will be exclusively the result of the higher profitability of its new foreign parent in another country. Its domestically owned competitor will not suffer this increased tax. In effect, the purchased company is being penalized by California for being owned by a more profitable foreign enterprise.

A second example involves a profitable foreign corporation attempting to enter the United States market and incurring significant start-up losses as a result. Notwithstanding actual economic loss in the United States, the California segments of the business will be required to pay California taxes on income that is being earned in Canada, has remained in Canada, and is not the product of the California operation. As a result, California operations are clearly being required to pay tax on income earned by a different entity outside the United States.

There are numerous other examples of events occurring outside the United States which do not affect California sales, property, or payroll in any way but never-

theless have an arbitrary effect on California taxable income. For example, a change in exchange rates, nationalization of a profitable foreign subsidiary, discovery of a new oil field, destruction of a plant or loss of a timber stand to fire, or the purchase of new profitable operations overseas all have this effect.

Many of the above examples are commonplace. The effect of the unitary method of apportionment applied internationally is to tax United States subsidiaries of more profitable foreign corporations on income that is earned by the foreign parent company, or its foreign subsidiaries, rather than by the United States subsidiary.

This Court has held that taxation of one person on the basis of the income of another person is unconstitutional. In *Hoeper v. Tax Commission of Wisconsin*, 284 U.S. 206 (1931), while determining the validity of a state income tax law that imposed combined reporting on members of a family, this Court held:

> We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income.

284 U.S. at 215.

In reality, the unitary method of apportionment, at least as applied on an international basis, results in an apportionment of taxable income to California, which in many cases is so arbitrary as to result in a denial of due process and a violation of the Commerce Clause.

Whether a result is "arbitrary" must be measured against what is possible or practical. Your *amici* take no position as to what may be practical or possible with respect to allocation of previously determined Federal taxable income between the various states of the United States. Your *amici* strongly contend, however, that the Federally adopted "arm's length—independent entity" approach for allocation of income between the United States and all foreign nations[9] achieves fewer arbitrary results than California's unitary method. The California method results in a global averaging of income in proportion to sales, property, and payroll. This method is totally insensitive to economic realities; results in obvious misallocation of income as illustrated above; ignores tax exemptions, cash grants and other incentives offered to investors by a number of foreign governments; and is further distorted by fluctuations in international currency exchange rates, which fluctuations are now substantial and frequent. The results of the California unitary method of apportionment are inconsistent with the Federal "arm's length—independent entity" approach.

The arguments advanced to support application of California's method to foreign subsidiaries of United States corporations reveal the inequities of applying that method to United States subsidiaries of foreign corporations. The primary theoretical justification for California's use of the unitary method internationally is that foreign subsidiaries of the unitary group do not adequately compensate their United States parent company for "intangible benefits" such as research and

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[9] In addition to being set out in all income tax treaties of the United States, this approach is applied to non-treaty nations also, pursuant to Section 482 of the Internal Revenue Code and regulations thereunder.

development, management expertise, know-how, financial support, and the provision of administrative services, the expense of which may be borne by the parent without corresponding payment from the subsidiary. Assuming the doubtful validity of this justification,[10] when the parent company providing the "intangible benefits" is located outside the United States, this theoretical justification should apportion more income to the foreign parent from the United States subsidiary. Nonetheless, by applying its system as it does, California imputes income to United States subsidiaries of your *amici* that are in start-up loss situations in the United States, and thereby ignores the identical arguments used in the instant California decision to justify California's unitary method of apportionment.

The injustice of California's global application of the unitary method is compounded by the fact that a corporation's presence in California subjects all foreign components of a non-American multi-national group to substantial additional expense. Foreign corporations, for example, may prepare their accounts in foreign currency rather than in dollars; may not use United States accounting conventions; and may compute taxable income in accordance with the laws of the foreign nations where they are doing business. Substantial costs and unproductive diversion of expertise unduly and harshly burden foreign multi-national groups that are subjected to the conversion of foreign operating results into United States currency in accordance with United

[10] The validity is doubtful because of the Internal Revenue Service practice of imputing income to cover such items. See, *e.g.*, Treasury Reg. § 1.482-2(c) requiring an "arm's length" charge for use of intangible property.

States accounting conventions, and recalculation of those results in accordance with United States tax principles merely because the enterprise has a minor subsidiary in California. The United States Treasury Department has also long since recognized the inherent difficulties of unitary reporting.[11]

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[11] This practice creates three types of problems: (1) It can result in a determination of income for state tax purposes which is substantially different than the income which would be attributed the corporation doing business in the state if an arm's-length or separate accounting method were used. To the extent that the relationship between the three apportionment factors (payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears in comparison to an arm's-length or separate accounting method to generate substantially more taxes for the states. (2) The practice can impose a substantial administrative burden, involving annual translation of the books of what may be a substantial number of foreign corporations into U.S. accounting concepts and U.S. currency. (3) The practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.

State Taxation of Foreign Source Income: Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 7 (1980) (Statement of Donald C. Lubick, former Assistant Secretary of Treasury for Tax Policy).

CONCLUSION

While this Court has addressed issues of unitary taxation in the domestic context, this case underscores the greater and different Constitutional issues raised by application of the unitary method internationally.

Your *amici* and their government are prohibited by the United States Constitution from effecting treaties with any of the 50 states and must, therefore, depend upon the Constitutional supremacy of the single voice with which the Federal government speaks in international affairs. Accordingly, your *amici* respectfully urge this Court to note probable jurisdiction so that this Court may decide the substantial Constitutional questions presented by the California court. Without review of this case, a California scheme of apportionment that burdens international commerce, that offends trading partners of the United States, and that imposes unconstitutional double taxation will be permitted to interfere in an area subject solely to Federal regulation.

Respectfully submitted,

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NO. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA, APPELLANT

v.

FRANCHISE TAX BOARD, APPELLEE

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

MEMORANDUM BY CATERPILLAR TRACTOR CO., ET AL. IN OPPOSITION TO SECOND MOTION OF APPELLANT TO EXPEDITE NOTING OF PROBABLE JURISDICTION

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TABLE OF AUTHORITIES

Cases

	Page
Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 84 Ill.2d 102, 417, N.E.2d 1343 (1981), prob. juris, noted, No. 81-349 (U.S. Sup. Ct. November 9, 1981)	1
Hans Pess' Sons, Inc. v. North Carolina, 283 U.S. 123, 75 L.Ed. 879, 51 S.Ct. 385 (1931).....	2
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980)..	3

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MEMORANDUM BY CATERPILLAR TRACTOR CO., ET AL. IN OPPOSITION TO SECOND MOTION OF APPELLANT TO EXPEDITE NOTING OF PROBABLE JURISDICTION

Caterpillar Tractor Co., et al. [Caterpillar], Appellee in Chicago Bridge & Iron Company v. Caterpillar Tractor Co., et al., No. 81-349, by Don S. Harnack, their attorney, respectfully oppose the Second Motion of Appellant [Container] to Expedite Noting of Probable Jurisdiction in No. 81-523 and to defer the decision in No. 81-349.

Container submits that "the fairest course of action to all parties" is to defer the decision in the Chicago Bridge & Iron v. Caterpillar case until this Court has heard the Container case. Caterpillar respectfully disagrees with Container's appraisal of what is "fair." The record in the Chicago Bridge & Iron v. Caterpillar case establishes that, without regard to the allegations by Chicago Bridge & Iron or Container, Caterpillar's income fairly apportionable to Illinois can only be determined by use of combination.

This Court's decision that Container is not wholly unitary or that combination does not properly apportion Container's income to California would not impact upon the constitutional propriety of the application of combination to Caterpillar. Caterpillar assumed and sustained the heavy burden of proof proscribed in Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931) when establishing its right to use combination. It is respectfully submitted that there is no basis to justify the deferral of this Court's decision in the event this Court chooses to note probably jurisdiction in the Container case.

Container concedes at page 2 of its motion that a case in controversy exists in the Chicago Bridge & Iron v. Caterpillar case, but suggests that the record is inadequate to present the constitutional issues with "sufficient clarity." This Court has before it sufficient submissions by Container to demonstrate that the only material differences between the two records are:

> (1) Caterpillar has established it is a worldwide unitary enterprise while Container urges that it is not unitary and combination "will violate the Due Process and Commerce clauses in many instances because the parent corporation [Container] and its foreign subsidiaries are not engaged in a unitary business." [Brief Amicus Curiae On The Merits In Support of Appellant, Submitted On Behalf of Container Corporation of America, p. 4]
>
> (2) Caterpillar has established that combination is the only method that fairly determines its income apportionable to Illinois while Container has submitted evidence which has, so far, been found to be inadequate to establish (a) Container and some or

all of its subsidiary operations are not unitary, (b) combination has resulted in an unreasonable apportionment of income to California, or (c) Container is entitled to statutory relief as provided by the California Revenue Code.

(3) Both Caterpillar and Container are domestically controlled groups of multi-national taxpayers. The record in both cases establishes without exception that combination applied to domestically controlled multi-national taxpayers does not offend our foreign trading partners. Additionally, the records in both Chicago Bridge & Iron and Container contain no evidence establishing the likelihood or possibility of the "impairment of federal uniformity" or an interference with the Federal Government's ability to "speak with one voice" in connection with foreign commerce.

(4) Neither the Chicago Bridge & Iron nor the Container record establishes either double taxation or the enhanced risk of double taxation by clear and cogent evidence. In any event this Court can and would rectify double taxation if established in an individual case. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980).

Caterpillar respectfully submits that the record, briefs and oral arguments in the Chicago Bridge & Iron case furnish this Court with an adequate basis to sustain the decision of the court below. If this Court wishes, the record in the Chicago Bridge & Iron case furnishes an opportunity to clarify this Court's prior decisions and to respond to those arguments which would severely limit such decisions.

If this Court chooses to reconsider the constitutional issues raised by Chicago Bridge & Iron in the context of the record created by Container, Caterpillar respectfully submits that the "fairest course of action" is to dismiss Chicago Bridge & Iron's appeal or to affirm the decision of the Illinois Supreme Court without plenary consideration. This course of action would grant to Caterpillar the relief to which it is entitled without jeopardizing Chicago Bridge & Iron's right to establish that combination would result in an unconstitutional apportionment of income to Illinois on its particular facts.

Respectfully submitted,

Don S. Harnack/s

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April 29, 1982

CERTIFICATE OF SERVICE

This is to certify that a copy of Caterpillar Tractor Co.'s Objections to the Second Motion of Appellant to Expedite Noting of Probable Jurisdiction was served this 29th day of April, 1982, by first class mail, postage prepaid, upon:

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA, *Appellant,*

v.

FRANCHISE TAX BOARD, *Appellee.*

On Appeal From the Court of Appeal of California, First Appellate District

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT AND BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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IN THE

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OCTOBER TERM, 1981

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CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD

Appellee.

On Appeal From the Court of Appeal of California, First Appellate District

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

The Committee on State Taxation of the Council of State Chambers of Commerce hereby respectfully moves for leave to file the attached brief *amicus curiae* in this case. The consent of the Attorney for the Appellant has been obtained. The consent of the Attorney for the Appellee was requested and refused.

The Council of State Chambers of Commerce (COUNCIL), organized in 1932, consists of 34 Chambers of Commerce. The Committee on State Taxation (COST), one of the three advisory committees of the COUNCIL, consists of 177 corporate members which conduct a substantial portion of the interstate and international business of the United States. One of COST's principal activities has been to work with the states and others toward developing fair and equitable national

standard in the income allocation and apportionment aspects of state taxation.

Member companies of COST are thus representative of that part of the nation's business sector which is most directly affected by state taxation of interstate and international business operations. COST is therefore vitally interested in cases such as this one which present issues significantly affecting the uniformity, certainty and fair apprortionment of state and local taxes.

The particular interest of COST in this case results from the presence of the following substantial question:

> Whether the Due Process Clause of the Fourteenth Amendment or the Commerce Clause of the Constitution of the United States was violated when the State of California included, for franchise tax purposes, the income of the foreign subsidiaries of Container Corporation of America in its "combined" apportionable base.

The United States Supreme Court has never decided the issue of whether the application by a state of a "worldwide combination" apportionment formula to a state taxpayer, such as Container Corporation, results in an arbitrary, unreasonable attribution of extraterritorial income to the state so as to offend the Due Process Clause of the Fourteenth Amendment and subject the taxpayer to multiple taxation prohibited by the Commerce Clause.

In an era of rapidly increasing state and local revenue needs, individual states are expanding efforts to maximize tax revenue from multistate and multinational businesses by taxing extraterritorial values. One method used by over-zealous states is an attempt to tax both hypothetical income (i.e., gross-up) and non-unitary intangible income. That method is being examined by this

Court in the current Term in the cases of *F. W. Woolworth Co.* v. *Taxation and Revenue Department of the State of New Mexico,* No. 80-1745 (Jurisdiction noted October 5, 1981), and *ASARCO, Inc. (formerly The American Smelting and Refining Co.)* v. *Idaho State Tax Commission,* No. 80-2015 (Jurisdiction noted October 5, 1981). Another method uses a "worldwide combination" formula. That method is being aggressively pursued by an increasing number of states, including Alaska, California, Colorado, Idaho, Illinois, Montana, North Dakota, Oregon, Utah and New York (for oil companies). Dozens of "worldwide combination" cases are now pending at various administrative and judicial levels. Establishment by this Court of Constitutional standards for fair apportionment in both the *Woolworth* and *ASARCO*-type cases and the "worldwide combination" cases is urgently needed. They are needed to assure a reasonably consistent and fair system of taxation throughout the nation which will (1) allow each state to receive its just share of the total tax contribution of the nation's business sector, (2) prevent inequity and (3) protect the Constitutional rights of multinational corporate taxpayers. This Court now has an opportunity to establish these standards by considering the "worldwide combination" issue in conjunction with the "gross-up" and non-unitary intangible income issues.

By this motion, COST seeks leave (1) to show that the decision of the Court of Appeal of California in this case is repugnant to longstanding judicial interpretations by this Court of the Due Process and Commerce Clauses of the Constitution and (2) to show the national detrimental effect that decision will have unless the Court establishes fair apportionment standards.

COST therefore urges that leave be granted to file a brief as *amicus curiae* and respectfully so moves the Court.

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TABLE OF CONTENTS

	Page
INTRODUCTORY STATEMENT	1
OPINIONS BELOW	1
INTEREST OF *AMICUS CURIAE*	2
SUMMARY OF ARGUMENT	2
ARGUMENT	3
CONCLUSION	9

TABLE OF AUTHORITIES

CASES:	Page
Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977)	6
Evco v. *Jones*, 409 U.S. 91 (1972)	7
Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980)	4, 6
Hans Rees' Sons v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931)	5
International Harvester Co. v. *Evatt*, 329 U.S. 416 (1947)	5
Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979)	6, 7, 8
Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980)	4
Moorman Mfg. Co. v. *Bair*, 437 U.S. 267 (1978)	4, 6
Norfolk & Western Railway Co. v. *Missouri State Tax Commission*, 390 U.S. 317 (1968)	6
Northwestern States Portland Cement Co. v. *Minnesota*, 358 U.S. 450 (1959)	4
Standard Oil Company v. *Peck*, 342 U.S. 382 (1952)	7
Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920)	5
Washington Revenue Dept. v. *Washington Stevedoring Cos.*, 435 U.S. 734 (1978)	6
CONSTITUTION:	
U.S. CONST. art I, § 8, cl.3	3, 5, 6, 7, 9
U.S. CONST. amend. XIV, §1	3, 4, 5, 6, 9

Table of Authorities — continued

OTHER AUTHORITIES:

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d. Sess. (1980) 4, 7

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-523

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD

Appellee.

On Appeal From the Court of Appeal of California, First Appellate District

BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as *amicus curiae* in support of the Jurisdictional Statement in the above-captioned case.

OPINIONS BELOW

The Opinion of the Court of Appeal of California, First Appellate District, is reported at 117 Cal. App. 3rd 988, 173 Cal. Rptr. 121 (1981); the memorandum opinion and judgement of the California Superior Court are not reported.

INTEREST OF *AMICUS CURIAE*

The interest of the Committe on State Taxation of the Council of State Chambers of Commerce is set forth in the accompanying Motion for Leave to File Brief *Amicus Curiae.*

SUMMARY OF ARGUMENT

California, for corporate franchise tax purposes, may compute the taxable base by application of an apportionment formula to the total "unitary" income of a taxpayer. The apportionment formula utilized to determine the amount of income attributable to the state includes three factors: property, sales and payroll.

The Court has long approved a state's use of an apportionment formula to derive income attributable to business conducted within the state. Application of a formulary apportionment method, however, must not produce unreasonable or grossly distorted results.

A basic assumption underlying the equitableness of an apportionment formula is that property and labor will produce approximately the same amount of income wherever located. That assumption can be shattered when such an apportionment formula is applied beyond the borders of the United States to "combined" companies operating in foreign countries. An arbitrary or distorted result is then produced as a result of the broad economic, political and social differences which exist between this country and most of the remainder of the world.

Inclusion of income of subsidiaries operating outside the United States in the apportionable base results in an

attribution of income so arbitrary as to offend the Due Process Clause of the Fourteenth Amendment and is violative of the Commerce Clause because it (1) constitutes an unreasonable burden on foreign commerce and (2) is contrary to, and interferes with, the established tax policy of the United States.

ARGUMENT

Distortion

The apportionment formula method has developed as a mechanism to apportion net income among taxing jurisdictions on the basis of the ratio that the corporate taxpayer's economic activities or values within a particular state bear to the total of such activities or values both within and without that particular taxing jurisdiction. Most of the states, including California, use a three-factor formula of property, payroll and sales. Implementation of this formula varies among the states. Under the California "combination" formula, the state apportions income by multiplying the total "unitary" income of the corporate taxpayer, its subsidiaries and affiliates, wherever earned, by a percentage derived from the average of the payroll, property and sales in California over total payroll, property and sales wherever located.

Fundamental to the equity of an apportionment formula is the need for all of the taxing jurisdictions to have roughly comparable factors, i.e., every dollar of sales, payroll and property must produce approximately the same amount of income regardless of where the business is being conducted. Within these limits, the use of the three-factor formula provides a fair measure of the total income earned by the business enterprise within the state and apportions the total tax burden among the various states.

The three-factor formula does not provide a fair measure when it is applied on a "worldwide combined" basis. Wage rates and productivity of labor differ substantially between the United States and most foreign countries. Major differences also exist in the costs and productivity of plant, equipment and other property. Property values and payroll costs tend to be higher in the United States than elsewhere. This distortion causes an excessive amount of income to be attributed to the "worldwide combination" state. *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means,* 96th Cong., 2d Sess. 167 (statement of Paul W. Cook); 193-194 (statement of Dallas A. Hurston); 259 (statement of William O. Hetts) (1980).

Due Process

The Court has repeatedly sanctioned application of an apportionment formula method for the purpose of state taxation of the income of a business operating in interstate commerce. It has long been established that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the states for tax purposes by formulas utilizing in-state aspects of interstate affairs". *Exxon Corp.* v. *Wisconsin Department of Revenue,* 447 U.S. 207, 219 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes,* 445 U.S. 425, 436 (1980); *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450, 460 (1959).

Where a state seeks to impose a tax on income generated by interstate and intrastate activities, the Due Process Clause of the Fourteenth Amendment requires that there be a " 'minimal connection' between the interstate activities and the taxing state, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise". *Mobil Oil Corp.* v. *Commissioner of Taxes,* 445 U.S. at 437. *See Moorman Mfg.*

Co. v. *Bair,* 437 U.S. 267, 272-273 (1978). If an apportionment formula results in the taxation of income out of all reasonable proportion to the corporation's business activities within the state, the formula violates the Due Process Clause.

Where an apportionment formula is applied on a "worldwide combination" basis, there is no rational relationship between the income attributed to the state and the intrastate values of the business enterprise. There are vast disparities in the productivity of payroll and property between the United States and most foreign countries. Thus, the inclusion of foreign operations in the apportionment formula results in gross distortion, both as to factor percentages used to determine the ratio of apportionable income and the correlative amount of income attributed to the state, out of all proportion to the business transacted within the state.

The difficulties inherent in fairly apportioning income among the various states in which a business is conducted have long been recognized. *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113, 120-121 (1920). Accordingly, the Court has ruled that the Commerce and Due Process Clauses of the United States Constitution require "rough approximation rather than precision" in a formula which apportions income of such an enterprise. *International Harvester Co.* v. *Evatt,* 329 U.S. 416, 422 (1947).

Nevertheless, the latitude offered the states is not total. If a taxpayer shows that "the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result", *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. at 121, or that the income attributed to the state was "out of all appropriate proportion to the business transacted . . . in that state", *Hans Rees' Sons* v.

North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931), or that the formula "led to a grossly distorted result", *Norfolk & Western Railway Co.* v. *Missouri State Tax Commission,* 390 U.S. 317, 326 (1968), then Due Process has been violated. *See Exxon Corp.* v. *Wisconsin Dept. of Revenue,* 447 U.S. at 220; *Moorman Mfg. Co.* v. *Bair,* 437 U.S. at 274.

Commerce Clause

Japan Line, Ltd. v. *County of Los Angeles,* 441 U.S. 434 (1979), sets forth the governing principles under the Commerce Clause. There, the Court reiterated the standard applicable to a tax on interstate commerce. "If the state tax 'is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state,' no impermissible burden on interstate commerce will be found." *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. at 444-445. *See Complete Auto Transit, Inc.* v. *Brady,* 430 U.S. 274, 279 (1977); *Washington Revenue Dept.* v. *Washington Stevedoring Cos.,* 435 U.S. 734, 750 (1978).

With respect to state taxation which impacts foreign commerce, the Court explained in *Japan Line* that two additional standards must be met (441 at 446, 448):

> "When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations beyond those articulated in *Complete Auto,* come into play. The first is the enhanced risk of multiple taxation.
>
> * * *
>
> "Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."

The Court then held that "[i]f a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause". 441 U.S. at 451.

The first test enunciated relates to the enhanced risk of multiple taxation and is herein applicable. Application of the apportionment formula method on a "worldwide combination" basis creates more than the risk of multiple taxation. In the instant case, it *does* produce multiple taxation. Income of each subsidiary is taxed in the foreign country in full and without any apportionment. By applying the apportionment method on a "worldwide combination" basis, income which has already been fully taxed in the foreign countries is attributed to California under the three-factor formula. Thus, to the extent such income is apportioned to California, it is indeed subjected to double taxation. *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means,* 96th Cong., 2d Sess. 193 (statement of Dallas A. Hurston); 315 (statement of Joseph H. Guttentag) (1980). Other states, which have or may adopt this worldwide approach, may subject this same foreign income to further taxation. Thus, state taxation under the "worldwide combination" apportionment formula method results in multiple taxation of foreign commerce.

The rationale of *Japan Line* is fully applicable in the instant case. The Constitutional limitations which apply to state taxing powers do not differentiate among different kinds of taxes. Taxes which result in multiple burdens on interstate or foreign commerce are invalid regardless of the kind of tax involved. *See, e.g., Evco* v. *Jones,* 409 U.S. 91 (1972); *Standard Oil Company* v. *Peck,* 342 U.S. 382 (1952). The gravamen of an invalid tax is its burden on commerce and not what it is called or to what asset it is applied.

Application of the apportionment formula method on a "worldwide combination" basis also violates the second test of *Japan Line* in that it impairs "federal uniformity in an area where federal uniformity is essential." 441 U.S. at 448. Under federal tax policy, the income of the parent and the income of subsidiaries operating outside the United States are determined on a separate corporate basis. Indeed, the major trading nations of the world and the tax treaties between the United States and other countries also apply this separate corporate entity approach pursuant to the internationally-accepted arm's length standard. The separate entity method and the "worldwide combination" method often apportion income as between countries quite differently. As a result, the "worldwide combination" method inevitably conflicts with the federal method making federal uniformity impossible in the field of foreign commerce, an area where the Court stated in *Japan Line* that federal policy must be supreme.

The "worldwide combination" apportionment method indirectly impacts foreign commerce in contravention of the principles promulgated in *Japan Line*. This circumvention should not be allowed.

CONCLUSION

For all the foregoing reasons, COST urges this Court to note probable jurisdiction in the present case and give plenary consideration to the Due Process Clause and Commerce Clause questions discussed in Appellant's Jurisdictional Statement.

Respectfully Submitted,

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MOTION OF EMI, LIMITED FOR LEAVE TO FILE BRIEF AMICUS CURIAE

AND

BRIEF AMICUS CURIAE IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

EMI, Limited, hereby respectfully moves for leave to file the accompanying brief as amicus curiae in this case. The consent of the attorney for the Appellant has been obtained. The consent of the attorney for the Appellee has been sought, but has neither been given nor denied.

EMI, Limited (hereinafter EMI), is a United Kingdom corporation, which does not have a permanent establishment in the United States, under the United States-United Kingdom Tax Convention, and which does not do business in the United States. EMI has subsidiaries which operate in more than 40 countries other than the United Kingdom, including the United States. Many of the corporations which operate in countries foreign to the United Kingdom are in the business of recording music or manufacturing and selling recorded music, principally on record disk, but also on tape or cassette. EMI has a United States subsidiary, Capitol Industries-EMI, Inc., which in turn has a subsidiary domiciled in Los Angeles, California, which records music, manufactures records, and sells records at wholesale. Capitol Industries-EMI, Inc., has filed California Franchise Tax returns of income, reporting its income on the unitary basis, combining

its operation inside of California with those outside of it, including those of its subsidiaries. It has not filed its California Franchise Tax return income combining itself with its parent corporation, EMI, or EMI's other subsidiaries. The California Franchise Tax Board has administratively combined Capitol Industries-EMI with EMI and its other subsidiaries, on a "music only" basis.

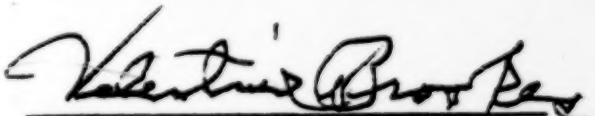
EMI has brought an action for an injunction in declaratory relief in the federal courts, and its case is on appeal to the Ninth Circuit Court of Appeals under the style EMI, Limited v. Bennett, et al., No. 80-4114. Capitol Industries-EMI, Inc. has also brought suit in the federal courts, and in a companion case its appeal is before the Ninth Circuit Court of Appeals under the style Capitol Industries-EMI, Inc. v. Bennett, et al., No. 80-4113. The two cases have been consolidated for oral argument, which is scheduled for October 15, 1981.

A principal contention of both EMI, Ltd., and Capitol Industries-EMI, Inc., is that the unitary combination which California seeks to impose on the two companies is an imposition on and attempted regulation of foreign commerce, and is barred by the United States Constitution, Article I, Sec. 8, cl. 3, as interpreted in this Court in Japan Line, Ltd. v. County of Los Angeles, 441 US 434 (1979).

While there may be constitutional limitations against state taxation of the income of a United Kingdom corporation not having a permanent establishment in the United States not presented in the case at bar, the Court's review of

this case and reversal of the California decision may well dispose of EMI's case as well as the case at bar.

Respectfully submitted,



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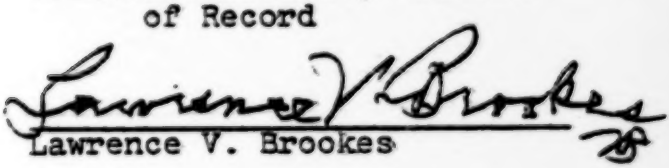

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TABLE OF CONTENTS

Interest of The Amicus 1

The Question Presented Is Substantial..... 2

I. The Decision in Japan Line, Ltd. v. County of Los Angeles, 441 US 434 (1979), Controls This Case..... 2

II. The Opinion Below Demonstrates Minimal Intercompany Sales Into or Out of The United States, and Therefore the Use of Formulary Apportionment Must Distort Taxable Income, So As To Subject Foreign Income to State Tax..... 16

AUTHORITIES CITED

Board of Trustees v. United States, 259 US 48 (1933) 10

Chy Lung v. Freeman, 92 US 275 (1876)..... 5

Complete Auto Transit v. Brady, 430 US 274 (1977)..... 8

Evco v. Jones, 409 US 71 (1972)..... 9, 10

Japan Line v. County of Los Angeles, 441 US 434 (1979)..... 2, 3, 4, 5, 7, 9, 11, 13, 19

J.D. Adams Mfg. Co. v. Storen, 304 US 307 (1938)..... 9, 10

Mobil Oil Co. v. Vermont, 445 US 425 (1980)..... 12, 13

Moorman Manufacturing Co. v. Bair, 437 US 267 (1978)..... 12

United States v. Pink, 315 US 203 (1942)..... 5

Washington Revenue Department v. Stevedoring Association, 435 US 734 (1978)..... 8, 9

INTEREST OF THE AMICUS

The interest of Amicus EMI, Limited, is set out in the accompanying motion of EMI, Limited for leave to file this brief as amicus curiae.

THE QUESTION PRESENTED IS SUBSTANTIAL

This case presents an important constitutional issue with respect to the imposition by the various states of their income taxes on income earned in foreign commerce by related corporations, which is apportioned by formula in a unitary combination, to the taxing state, and there taxed, when the income already has been subjected to tax in the country where earned. The case presents the issue whether the standards set forth in Japan Line, Ltd. v. County of Los Angeles, dealing with state taxation of foreign commerce, apply to income taxation as well as to property taxation.

I. THE DECISION IN JAPAN LINE, LTD. v. COUNTY OF LOS ANGELES, 441 US 434 (1979), CONTROLS THIS CASE.

The effect of the Supreme Court decision in Japan Line, Ltd. v. County of Los Angeles, 441 US 434 (1979) is to invalidate California's taxing an apportioned share of the foreign

income of Container Corporation's foreign subsidiaries, income which was fully taxed by the host countries with a resulting duplicating international taxation which violates the Foreign Commerce Clause. The Japan Line case involved the effort of Los Angeles County to impose an apportioned property tax on containers owned by a Japanese steamship company which Japan had taxed at their full value, and the effect of the California tax was to impose a multiple burden on the machinery of foreign commerce. The California Supreme Court has sustained the tax. This Court held it unconstitutional. The same considerations apply here.

The bases of the decision were tripartite: First, the United States must speak with a single voice in foreign matters, and therefore the states cannot be permitted to intrude on the area; second, the theory of apportionment is workable when dealing with interstate commerce because the United States Supreme

Court has the power to enforce apportionment among all of the taxing parties involved, but in foreign commerce the United States Supreme Court is powerless to enforce apportionment on the foreign country which has the right to impose a tax on the full value of the property; and third, to permit any state by an asymmetric taxing method to impose multiple burdens on foreign commerce would invite retaliation by the foreign countries, and the retaliation would be against all 50 of the United States, and not merely against the offending state.

The Court below held that this Ccurt's decision is inapplicable here, where the tax is not a property tax. That contention will not survive analysis, or even a critical reading of this Court's opinion.

Analysis of the three prongs on which the Japan Line decision is based shows that each of them applies to taxes on or measured by net income, as much as to property taxes.

There can be no logical justification for imposing the single-voice doctrine on state property taxes and exempting from it state income taxes. We doubt that anyone can even suggest a reason for permitting the United States to speak with fifty voices where income taxes are involved but for requiring a single voice only where property taxes are involved. Indeed, the doctrine is not confined to taxes, but extends to all areas of possible state legislation. A century ago it was applied to invalidate a California law requiring bonds of Chinese immigrants. See Chy Lung v. Freeman 92 US 275 (1876), cited in footnote 16 of Japan Line. The phrase "one voice" appears to have originated in Mr. Justice Frankfurter's concurring opinion in United States v. Pink 315 US 203, 242 (1942), where the opinion for the Court used the phrase "sole organ" in speaking of the Executive's power. 315 US 203, 223, 229. In Pink an executive agreement was held

effective to override New York law and public policy determining ownership of property.

The second prong of the decision was that the United States lacks power to compel foreign countries to refrain from taxing the entire value of property over which they have taxing jurisdiction, and instead to adopt the apportionment principle. That lack of power to compel international apportionment also exists for a tax on or measured by net income.

The third prong of the decision was that to permit California to adopt any asymmetric method of taxing when the method produced multiple taxation would inevitably invite retaliation by foreign countries. California has adopted an asymmetric income tax system. The possibility of retaliation for multiplication of tax burden is greater for an income tax than for a property tax. The community of nations has exhibited far more concern with duplicating income taxes than

with duplicating property taxes. The extensive system of bilateral tax treaties deals with income taxes, and rarely with property taxes except for the blanket nondiscriminatory clauses. The United States is a party to 35 income tax treaties, plus five which at last count had been signed but not ratified. If the California tax violates those treaties they may be renounced by the foreign signatories and retaliatory measures substituted. If that should occur, as the Supreme Court pointed out in Japan Line, the retaliation will be against the entire 50 states, not merely against the one which provoked it.

The Japan Line opinion contains ample evidence, affirmative in nature, that this Court did not intend to confine its decision to property taxes. The structure of the opinion as well as the language shows the Court intended to enunciate principles applicable to all types of state taxes, as well as to

the case before it. Thus, in Part B of the opinion (441 US 434, 444) the Court stated the principles limiting all state taxation of foreign commerce, and in Part C (441 US 434, 451) applied them to the particular tax before it and demonstrated why the tax was inconsistent with those principles.

The discussion of the governing principles made no distinction at all between kinds of taxes. This Court distinguished Complete Auto Transit v. Brady, 430 US 274 (1977), and Washington Revenue Department v. Stevedoring Association, 435 US 734 (1978), on the ground that they involved interstate commerce instead of foreign commerce. The first case involved a privilege tax measured by gross sales or gross income, and the second one involved an occupation privilege tax measured by gross income. This Court did not distinguish them because they were not property tax cases but instead recognized that they would have had relevance if the tax before it had involved

interstate commerce instead of foreign commerce. (441 US 434 at p. 455) In considering the effect of multiple taxation on foreign commerce, the first case cited in the Japan Line opinion was Evco v. Jones, 409 US 91 (1972), which involved a state sales tax. The opinion also cited J. D. Adams Manufacturing Co. v. Storen, 304 US 307 (1938), which involved a state gross income tax. It was from this line of cases, involving sales taxes and gross income taxes, that this Court evolved the doctrine that apportionment among taxing jurisdictions was necessary to preserve the validity of taxes on instrumentalities of interstate commerce. This was the foundation for its consideration of the question whether apportionment such as California had invoked was sufficient to save the tax when it was on an instrumentality of foreign commerce, instead of interstate commerce. The opinion quoted language from Washington Revenue Department, involving an occupation privilege

tax measured by gross income, and Evco v. Jones, involving a state sales tax, and the latter quoted language from J.D. Adams Manufacturing Co., which involved a gross income tax. This Court could not have thought these cases relevant only to property taxes.

In addressing the question whether a different rule should apply in foreign commerce than in interstate commerce, this Court declared that a state tax on foreign commerce could impair federal uniformity in an area where federal uniformity is essential. The opinion quoted (441 US 424, 448):

> "Foreign commerce is eminently a matter of national concern. 'In international relations and with respect to foreign intercourse and trade, the people of the United States act through a single government with unified and adequate national power.'"

from Board of Trustees v. United States, 289 US 48 (1933), which was an import duty case, not a property tax case. It was the opinion stated next that in a foreign commerce context (441 US 434, 451):

> "... a court must ... inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts it is unconstitutional under the Commerce Clause." (Emphasis added)

It is clear that the Court meant: "If any state tax contravenes," etc.; and not merely: "If a state property tax contravenes," etc.

The Japan Line opinion emphasized the necessity of speaking with one voice in regulating foreign trade. The Court explained that the single voice doctrine required uniformity of treatment by each state of the United States, so that foreign commerce would not be subject to "varying degrees of multiple taxation" depending on the state in which it happened to arrive (441 US 434, 453). It pointed out that the asymmetry of California's tax prevented uniformity. The same is true

with California's franchise tax. California stands almost alone in its methods. There can be no rational basis for permitting "varying degrees of multiple (income) taxation" but frowning on "varying degrees of multiple (property) taxation."

Finally, the Court rejected the County's contention that Moorman Manufacturing Co. v. Bair, 437 US 267 (1978) permitted multiple taxation by stating (441 US 434, 456):

> "...Moorman finally, concerned interstate commerce. This case concerns foreign commerce."

The Court did not distinguish the Moorman case because it was an income tax case.

The Court also spoke of international disputes which would occur over reconciling apportionment formulae, if the states were allowed to impose an apportioned tax. 441 US 434, 448. This concern cannot possibly be less if the apportioned tax is on income instead of tangible property.

In Mobil Oil Corp. v. Commissioner of Taxes,

445 US 425 (1980), this Court considered whether Japan Line established principles applicable to a State net income tax. Part B of the prevailing opinion is entirely devoted to discussing the possible application of the Japan Line case to the Mobil Oil case, and the seven paragraphs of that Part could have been reduced to one if the Court meant that Japan Line was inapplicable because it involved a property tax. The Court distinguished Japan Line by stating (445 US at 448):

> "Japan Line, moreover, focused on problems of duplicating taxation at the international level, while appellant here has confined its argument to the wholly different sphere of multiple taxation among our States."

The international community has evidenced much greater concern with the burgeoning effect of duplicating tax burdens through the income tax then through the property tax. The United States has signed more than forty income tax conventions with foreign countries, but no property tax conventions. Where property taxes are dealt with in international

treaties they are dealt with as an incident either to the income tax convention or to treaties of commerce and navigation.

Both the Government of the United Kingdom and the Commission of the European Economic Community have lodged formal protests with the United States State Department over the California apportionment unitary practices, and have called them a violation of international law. The letter to the Department of State from the Commission of the European Economic Community is particularly strong in demanding that the United States Government make some change to eliminate California's departure from the practice prevailing among sovereign nations, and to compel the use by California of the same system of determining source of taxable income as is used by the United States Internal Revenue Service, and by the bilateral treaties in effect. In all such treaties, the rule in effect is that the independence of the foreign subsidiary be recognized, that it be regarded as a

separate taxpayer from the parent, and that the Internal Revenue Service employ the arms-length standard to insure that the net income being reported for taxation is the same as would be produced by arms-length bargaining between the two corporations, using the same fair price standard which could be expected to be operative if the two corporations were not commonly owned. This is the system the Government of the United Kingdom and the Commission of the European Economic Community demanded that the United States Government enforce on the State of California. To date, nothing has been done to bring California into correspondence with the rest of the world.

As a practical matter, action by the United States Congress is uncertain, because the foreign governments do not have elected representatives voting in either house of the Congress. California, however, has a considerable representation in the House of Representatives and the usual allotment of Senators.

Nor do foreign corporations, by which we mean corporations with their headquarters in and most of their shareholders also in foreign countries, have a significant voice with the United States Congress. Their reliance must be on international law and the United States Constitution, and it is the United States Constitution which amicus is asking this Court to interpret.

II. THE OPINION BELOW DEMONSTRATES MINIMAL INTERCOMPANY SALES INTO OR OUT OF THE UNITED STATES, AND THEREFORE THE USE OF FORMULARY APPORTIONMENT MUST DISTORT TAXABLE INCOME, SO AS TO SUBJECT FOREIGN INCOME TO STATE TAX.

Container Corporation does not present a case where extensive inter-company transfers of raw materials product know-how permit the companies not subject to the state's tax to profit at the expense of the company (or companies) whose net income properly is subject to tax. The Court below explicitly acknowledged this. (Jurisdictional Statement, A-8 - A-9)

The record below shows that foreign workers are paid substantially less to produce the same quantity of product and that the foreign subsidiaries could be expected to be more profitable than U.S. operations (Jurisdictional Statement, pp. 18, 19), and the greater profits can not be attributed to the U.S. operations. Necessarily, the income which when added to U.S. income and apportioned is taxed in California, must have been earned in the foreign countries exclusively; California should not be permitted to tax it as the price for appellant's engaging in foreign commerce.

California has shown no concern with whether or not unusual circumstances such as those demonstrated in the Jurisdictional Statement (pp. 17-20) exist, but applies its formula rigidly in all instances in which it considers that a unitary business exists, operating in California and elsewhere in the world, whether in foreign countries or in the United States.

The typical foreign subsidiary,

exemplified by the facts of this case, will pay income taxes to the host country on its entire net income. The United States tax laws permit the parent corporation, if a consolidated return is filed, to claim a credit for the tax paid by the subsidiary to the foreign country. If a United States consolidated return is not filed, then the United States parent is taxable only on the dividends which it receives from its foreign subsidiary, and dividends are paid from net income after taxes, so the arithmetic effect is that the United States allows a deduction for taxes paid to the foreign country where no consolidated return is filed, and the credit for the foreign taxes against the United States tax if a consolidated return is filed.

California, however, is different. It adds the foreign source net income before taxes to the parent's income. California allows neither a deduction nor a credit for the taxes paid by the foreign operating subsidiary

to the host country. Hence the income California allocates to itself which has been taxed by the foreign country is taxed twice, once in the foreign, host country, and once in California. See Jurisdictional Statement pp. 9-12. This is the same burden which in Japan Lines v. County of Los Angeles, supra, 441 US 434, this Court held impermissible.

CONCLUSION

The California unitary combination of foreign affiliated corporations and corporate parents doing business in California, apportioned by a three-factor formula, taxes foreign income and requires submission to the State of California of information extraterritorial to that state and to the United States. The tax ultimately found subjects foreign income to multiple taxation, acts as an impermissible regulation of foreign commerce, and disturbs international relations

of the United States. For these reasons, it is in clear violation of the United States Constitution, Article I, Sec. 8, Cl. 3 (foreign commerce). For these reasons, jurisdiction of the appeal should be noted.

Respectfully submitted,

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NO. 81-523
IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1981
CONTAINER CORP OF AMERICA, APPELLATE
V FRANCHISE TAX BOARD, APPELLEE
OBJECTIONS TO SECOND MOTION OF CONTAINER CORP OF AMERICA
NOW COMES THE STATE OF ILLINOIS, ET AL, BY TYRONE C. FAHNER, ATTORNEY GENERAL FOR THE STATE OF ILLINOIS, AND RESPECTFULLY OBJECTS TO THAT PART OF THE SECOND MOTION BY CONTAINER CORP OF AMERICA TO EXPEDITE NOTING OF PROBABLE JURISDICTION WHICH DECLARES THAT WHICH THE ISSUE OF WORLDWIDE UNITARY APPORTIONMENT
"...REQUIRES, IS FOR THE COURT TO DEFER DECISION IN CHICAGO BRIDGE & IRON CO (NO. 81-349) AND NOTE PROBABLE JURISDICTION IN CONTAINER CORP OF AMERICA, NO. 81-523. (SECOND AND MOTION AT P.4, EMPHASIS ADDED) IT IS RESPECTFULLY SUBMITTED THAT THE GROUNDS STATED BY CONTAINER IN ITS SECOND MOTION ARE INCORRECT AND THE RESULT IT SEEKS WOULD CAUSE ILLINOIS IRRETRIEVABLE LOSSES, AS FOLLOWS:

1. CONTAINER CORP OF AMERICA AGREES WITH THE UNITED STATES SOLICITOR GENERAL THAT "... THERE IS NO DOUBT THAT THERE IS A CASE OR CONTROVERSY..." IN THE CHICAGO BRIDGE & IRON APPEAL. S CONTAINER ERRONEOUSLY SUGGESTS THAT THE CONSTITUTIONAL ISSUES ARE NOT PRESENTED WITH "SUFFICIENT CLEARITY" IN CHICAGO BRIDGE AND IRON DUE TO ABSENCE OF "PROOF" OF DOUBLE TAXATION, BOTH CONTAINER AND CHICAGO BRIDGE & IRON INSISTS THAT SEPARATE ACCOUNTING (ARMS LENGTHS) IS THE "PROOF" NECESSARY TO CLAIM EXTRATERRITORIAL DOUBLE, TAXATION, (JURISDICTIONAL STATEMENT OF CONTAINER AT P. 10) SUCH "PROOF" HAS BEEN REPEATEDLY REJECTED BY THIS COURT, AND THERE IS NO DIFFERENCE BETWEEN THE CONTAINER AND CHICAGO BRIDGE & IRON APPEALS OF THIS FUNDAMENTAL ISSUE.

2. UNLIKE CHICAGO BRIDGE & IRON, CONTAINER DOES NOT LIMIT ITS ISSUE TO WHETHER WORLDWIDE UNITARY APPORTIONMENT IS PROHIBITED BY OUR CONSTITUTION. RATHER, CONTAINER SEEKS ALTERNATIVE RELIEF FROM WORLDWIDE UNITARY APPORTIONMENT, CLAIMING ITS RECORD ESTABLISHES "... AN ACCEPTABLE LEVEL OF DISTORTION SO AS TO VIOLATE NEW PROCESS." (JURISDICTIONAL STATEMENT AT P. 10, BRIEF IN OPPOSITION TO MOTION TO AFFIRM OR DISMISS, PP. 3-4). IF THIS COURT CONCURRED WITH THESE

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ARGUMENTS FOR RELIEF, THEN THE CONSTITUTIONAL ISSUES IN CHICAGO BRIDGE & IRON WOULD NEVER BE REACHED IN THE CONTAINER APPEAL.

3. CONTAINER ALSO CONCLUDES, IN ERROR, THAT THE IDENTICAL CONSTITUTIONAL ISSUES PRESENTED IN BOTH APPEALS SOUGHT TO BE DECIDED ON THE "WELL-DEVELOPED" RECORD IN CONTAINER. IN CONTAINER'S JURISDICTIONAL STATEMENT, IT ASSERTS THAT ITS FOREIGN SUBSIDIARIES"... ARE NOT A PART OF A FUNCTIONALLY INTEGRATED BUSINESS WITH THE PARENT..." (QUESTION PRESENTED AT P. 5). THIS ARGUMENT IS REPEATED AGAIN IN ITS STATEMENT OF FACTS AT PP. 4-8 OF ITS JURISDICTIONAL STATEMENT AND IN ITS ARGUMENT AT PP. 21-23) THUS, CONTAINER PRESENTS AN ISSUE AS TO WHETHER ITS FOREIGN SUBSIDIARIES ARE FUNCTIONALLY INTEGRATED WITH ITS UNITED STATES PARENT. THIS IS IN MARKED CONTRAST TO THE EVIDENCE THAT CATERPILLAR'S FOREIGN SUBSIDIARIES ARE SO FUNCTIONALLY INTEGRATED WITH ITS ILLINOIS PARENT AS TO MAKE SEPARATE GEOGRAPHICAL ACCOUNTING AND IMPOSSIBILITY.

4. UNDER ILLINOIS LAW, IT IS NOT POSSIBLE TO AVOID PAYMENT OF REFUNDS DUE TO CORPORATIONS ENTITLED TO REFUNDS BASED ON WORLDWIDE UNITARY APPORTIONMENT, ONLY THE PAYMENT TO CATERPILLAR TRACTOR CO, ET. AL., CAN BE DEFERRED UNTIL FINAL DECISION OF THIS COURT ON THE CONSTITUTIONAL ISSUES PRESENTED. ONCE THE ILLINOIS SUPREME COURT HELD THAT ALL ILLINOIS TAXPAYERS ACTING AS A SINGLE BUSINESS UNIT MUST BE ACCORDED THE SAME FAIR APPORTIONMENT, (NOT JUST CATERPILLAR AND CHICAGO BRIDGE & IRON) VALID REFUND CLAIMS OF OTHER ILLINOIS TAXPAYERS BECAME DUE. CONVERSELY, CORPORATIONS WHICH OWE ADDITIONAL ILLINOIS TAXES ARE CONTESTING THEIR LIABILITY ON THE SAME GROUNDS AS CHICAGO BRIDGE & IRON. THIS LAVES ILLINOIS IN THE POSITION OF HAVING TO PAY REFUNDS BUT UNABLE TO COLLECT T UNABLE TO COLFCTION DEFICIENCYS BASED ON WORLDWIDE UNITARY APPORTIONMENT UNTIL THIS COURT ACTS. AS NOTED IN ILLINOIS MEMORANDUM OF CO-APPELLEE TO THIS COURT, THERE WERE SOME 1,458 NEW CLAIMS FOR REFUND LAST YEAR TOTALLING $32,141,910. THUS THE SECOND MOTION OF CONTAINER "...TO DEFER DECISION IN CHICAGO BRIDGE & IRON..." WOULD RESULT IN IRRETRIEVEABLE LOSES TO ILLINOIS.

CONTAINER STATES THAT IT HAS "...A KEEN AWARENESS OF THE LIMITATIONS OF, AND HEAVY DEMANDS UPON, THE COURT'S DOCKET AND THE NEED TO AVOID FULL BRIEFING AND ARGUMENT IN DUPLICATIVE CASES." (SECOND MOTION AT P. 8) IN VIEW OF THE FACT THAT CONTAINER PRESENTS THE ISSUE OF WHETHER ITS FOREIGN SUBSIDIARIES ARE EVEN PART OF ITS UNITARY OPERATIONS, IT IS EVIDENT THAT A DECISION BY THIS COURT THAT SUCH FOREIGN SUBSIDIARIES ARE, AS A MATTER OF LAW, SEPARATE, NON UNITARY ENTERPRISES, WOULD LEAVE THE ISSUE OF CONSTITUTIONAL VALIDITY OF WORLDWIDE UNITARY APPORTIONMENT UNANSWERED.

IT WOULD BE INAPPROPRIATE FOR THE STATE OF ILLINOIS TO COMMENT UPON WHETHER NOTING OF PROBABLE JURISDICTION IN CONTAINER CORP OF AMERICA SHOULD BE EXPEDITED, HOWEVER, THE STATE OF ILLINOIS OPPOSES, IN THE STRONGEST MEASURE, CONTAINER'S SECOND EFFORT TO "...DEFER DECISION IN CHICAGO BRIDGE & IRON CO..." FOR EACH OF THE REASONS STATED ABOVE.

RESPECTFULLY SUBMITTED

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No. 81-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Supreme Court of California

MOTION OF NATIONAL ASSOCIATION OF MANUFACTURERS FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

AND

BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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QUESTION PRESENTED

California uses a formula for calculating corporate taxable income that attributes to California the same proportion of a company's entire income that property, payroll and sales in California bear to the company's entire property, payroll and sales.

The question is whether California's application of that formula to the combined income of a taxpayer and its foreign subsidiaries, which generally have lower wages and higher profitability, so unfairly apportions income as to offend due process.

A second question is whether that formula, which taxes income also taxed by the foreign subsidiaries' domiciliary countries, impermissibly discriminates against foreign commerce.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Supreme Court of California

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

The National Association of Manufacturers hereby respectfully moves for leave to file the accompanying brief as *amicus curiae* in this case. The consent of the Attorney for the Appellant has been obtained. The consent of the Attorney for the Appellee has been denied as the Appellee intends to oppose jurisdiction.

The National Association of Manufacturers (NAM) is a non-profit voluntary business association incorporated under the laws of the State of New York. NAM has a membership of approximately 11,600 manufacturing and related business concerns representing an estimated 85 percent of all employees engaged in manufacturing nationwide. Further, of the member companies, a significant percentage have foreign subsidiaries and operations which provide foreign source income.

NAM members are located in forty-six states which have a state corporate income tax. NAM is concerned that the issues presented in this case could have broad reaching effect in other states where member domestic companies with foreign subsidiaries are located. We believe that unless this Court can resolve the issue of how the three-factor apportionment formula is to be applied to combined world-wide income from foreign and domestic operations, the interests of many of our members will be jeopardized in states other than California. Further, we believe that the application of the formula to worldwide income results in multiple taxation which is violative to the Commerce Clause. Thus, we feel this case presents the type of issue that is worthy of consideration by this Court.

Due to the diverse membership base of NAM, we believe that our filing a brief as *amicus curiae* will give a broader perspective on the issues presented to this Court on appeal.

Accordingly, NAM respectfully requests that it be granted leave to file the accompanying brief as *amicus curiae.*

Respectfully submitted,

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TABLE OF CONTENTS

	Page
INTEREST OF THE AMICUS	1
THE QUESTION PRESENTED IS SUBSTANTIAL	1
CONCLUSION	15

TABLE OF AUTHORITIES

CASES:

Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924)	3
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)	10, 11
Department of Revenue of State of Washington v. Assn. of Washington Stevedoring Co., 435 U.S. 734 (1978)	11
Evco v. Jones, 409 U.S. 91 (1972)	11
Fargo v. Hart, 193 U.S. 490 (1940)	3
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	10, 11, 12, 13, 14, 15
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980)	3, 12
Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) *reh. denied*, 439 U.S. 885 (1978)	4, 11
Nashville, C. & St. L. Ry. Co. v. Browning, 310 U.S. 362 (1940)	3, 4
Norfolk & Western Ry. Co. v. Missouri State Tax Commission, 390 U.S. 317 (1968)	2
Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959)	2
Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169 (1949), *reh. denied* 336 U.S. 928 (1949)	
U.S. Steel Corporation v. Multistate Tax Commission, 434 U.S. 452 (1978)	3
Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940)	2

TABLE OF AUTHORITIES—Continued

CONSTITUTION: Page

Commerce Clause, Article I § 8 Cl. 3.....10, 11, 12, 13, 15
Due Process Clause, Amendment XIV § 1 ..... 2, 15

STATUTES:

California Tax and Revenue Code (Deering) §§ 25101, 25128 2
United States Code Annotated, Title 26 §§ 891, 901 et seq. 13, 14

OTHER AUTHORITIES:

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before The House Comm. on Ways and Means, 96th Cong., 2d Sess. 1980.....9, 10, 14
Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 1977..4, 5, 13, 14
Testimony of Dr. John McDonald, Professor, Stanford University, Reporter's Transcript 9
Unpublished Statistics Prepared by the U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, March 1981 .....5, 6, 7, 8

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-

CONTAINER CORPORATION OF AMERICA,
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v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Supreme Court of California

BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

INTEREST OF THE *AMICUS*

The interest of the *Amicus* National Association of Manufacturers (NAM) which consists of over 11,600 interstate and international companies, is set out in the accompanying motion of NAM for leave to file this brief as *amicus curiae.*

THE QUESTION PRESENTED IS SUBSTANTIAL

This case presents an important and unresolved constitutional issue: whether a state may, by its income apportionment formula, tax income of a taxpayer's foreign subsidiaries, which is already taxed by the subsidiaries' domicile nations.

California imposes a tax on the income of corporations doing business in the state. In the case of what it deems "unitary" or functionally integrated companies with foreign (or interstate) subsidiaries, California imposes its tax on the portion of the company's combined worldwide income that it deems allocable to California. It determines that portion by (1) calculating the average of three ratios (the ratios of the company's property, payroll and sales in California respectively to its property, payroll and sales worldwide) and (2) applying that average ratio to combined income of the taxpayer and its foreign subsidiaries. Cal. Tax and Revenue Code §§ 25101, 25128 (Deering).

1.a. *Due Process Requirements.* In extending its formula of income apportionment to include the "foreign source income" of a taxpayer's foreign subsidiaries, California offends due process by arrogating corporate income to the state out of all proportion to the income produced within the state.

This Court has held that a state may impose a tax on a non-domiciliary corporation doing business within the state, "if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444. That requirement is satisfied "if the tax is fairly apportioned to the commerce carried on within the State." *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169, 174; *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 452. In *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 325, the Court stated the limits of a state's taxing power as follows:

> A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the

> peculiarities of a given enterprise, to "project the taxing power of the state plainly beyond its borders." *Nashville, C. & St. L.Ry. Co. v. Browning*, 310 U.S. 362, 365 (1940). Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing state. *Fargo v. Hart*, 193 U.S. 490, 499-500 (1940) [footnote omitted].

The Court has also approved state taxation of unitary businesses operating both within the state and abroad, provided a fair apportionment is made. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 282 ("the State was justified in attributing to New York a *just proportion* of the profits earned by the Company from such unitary business" [emphasis added]).

More recently, in *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425, 438-439, the Court sustained Vermont's taxation of dividends received by a New York corporation from its foreign subsidiaries, but only upon the stipulation of Mobil that the dividends were taxable by the taxpayer's U.S. commercial domicile (445 U.S. at 447) and that Mobil did not dispute "the accuracy or fairness of Vermont's apportionment formula" 445 U.S. at 434. As to the latter concession, the Court noted that this limitation by Mobil "substantially narrows the issues before us. In deciding the appeal, we do not consider whether application of Vermont's [three factor] formula produced a fair attribution of appellant's [foreign] dividend income to that State". *Ibid.* Thus the issue presented here of the arrogation to the State, by the three factor formula, of income of foreign subsidiaries remains open— and important.

b. *The Three-Factor Formula.* Nearly all states imposing corporate income taxes use a three factor formula, involving property, payroll and sales, to allocate income of unitary interstate businesses. See *U.S. Steel Corpora-*

tion v. Multistate Tax Commission, 434 U.S. 452; *Moorman Mfg. v. Bair*, 437 U.S. 267, 283, (Powell, J. dissenting). This results from the fact that the three factor formulas "while not perfect, reflect more accurately the realities of the business and tax world." *Moorman Mfg. Co. v. Bair, supra*, 437 U.S. at 282 (Blackmun, J. dissenting).

The basis of the general acceptance of the three factor system for apportionment of the income of interstate businesses is an assumption so fundamental that it is rarely stated: that each dollar expended for property or payroll or received from sales in one state has approximately the same relation to income as each dollar of property, payroll or sales in another state. While this assumption may be reasonable as applied to the relatively homogenous states of the United States, it wholly fails as applied to the foreign nations vis-a-vis a state of the United States. Foreign wages are generally lower than U.S. wages and the profitability of foreign subsidiaries generally higher. Thus, the application of the three factor apportionment system to the combined worldwide net income of multinational corporations inevitably apportions foreign source income to the U.S. taxing states and "project[s] the taxing power of the state plainly beyond its borders." *Nashville, C. & St. L.Ry. Co. v. Browning*, 310 U.S. 362, 365.[1]

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[1] As stated by then Assistant Secretary of the Treasury, Laurence N. Woodworth:

> Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case [with respect to subsidiaries in foreign nations]. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount

The distortions that are inherent in California's allocation formula can be demonstrated by an examination of the payroll element of the formula. Table I compares the average wages paid to manufacturing employees in a variety of industrialized and nonindustrialized countries. As that table demonstrates, compensation varies widely from country to country. For example, in 1978 (the most recent year for which final figures are available), the average hourly compensation in the U.S. was $8.31. By contrast, international salaries in 1978 ranged from a low of $.80 (or 9.6 percent of U.S. wages) in Taiwan to a high of $10.42 (or 125.4 percent of U.S. wages) in Luxembourg. Thus, for the same payroll expenditure, a company could receive 10 hours and 45 minutes of work in Taiwan for one hour of work in the U.S., or 45 minutes of work in Luxembourg. Even allowing for different rates of productivity, it is apparent that a strict dollar for dollar comparison of payroll costs will not accurately reflect the income attributable to expenditures in the U.S. and in other countries. This is particularly true in the case of labor intensive manufacturing industries.[2]

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to taxation by a state government of the foreign income of a foreign corporation.

Tax treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 34 (1977) (Statement of Laurence N. Woodworth).

[2] In this regard, Dr. Woodworth further noted:

> . . . [L]abor costs vary substantially among countries—very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California. *Ibid.*

TABLE I

HOURLY COMPENSATION OF EMPLOYEES IN MANUFACTURING (Wages plus benefits)—1975-1980

Wages—Current U.S. Dollars

Country	1975	1976	1977	1978	1979 Estimated	1980 Estimated
United States	6.35	6.92	7.59	8.31	9.06	9.92
Austria	n/a	4.33	5.19	6.22	7.21	7.90
Belgium	6.60	7.02	8.38	10.18	11.91	13.18
Denmark	6.33	6.66	7.28	8.80	10.50	10.93
Finland	4.70	5.34	5.69	5.94	7.55	8.25
France	4.63	4.83	5.42	6.70	8.11	9.46
Germany	6.24	6.57	7.70	9.43	10.99	11.94
Greece	1.40	1.59	1.91	2.36	2.83	3.12
Ireland	3.01	2.86	3.24	4.13	5.22	6.38
Italy	4.65	4.42	5.13	6.18	7.54	9.01
Luxembourg	6.37	7.00	8.31	10.42	11.67	n/a
Netherlands	6.60	6.99	8.11	9.84	11.30	12.18
Norway	6.78	7.48	8.49	9.44	10.05	10.85
Portugal	1.58	1.66	1.58	1.63	1.68	n/a
Spain	2.55	2.85	3.19	3.83	5.35	5.96
Sweden	7.18	8.21	8.85	9.65	11.33	12.60
Switzerland	6.07	6.42	6.87	9.68	10.60	11.09
Turkey	0.70	0.89	0.80	1.05	1.11	n/a
United Kingdom	3.27	3.12	3.34	4.26	5.44	7.07

Canada	6.11	7.20	7.55	7.69	8.21	9.06
Brazil	1.13	1.29	1.46	1.67	1.73	n/a
Mexico	1.89	1.95	1.75	2.00	2.31	2.76
Venezuela	2.03	2.04	2.20	2.47	2.61	n/a
Australia	5.22	5.64	5.77	6.00	6.40	7.23
Hong Kong	0.71	0.87	0.99	1.13	1.25	1.51
India	0.19	0.29	0.32	n/a	n/a	n/a
Israel	2.25	2.37	2.68	2.57	3.30	3.68
Japan	3.05	3.30	4.03	5.54	5.59	5.88
Korea	0.37	0.47	0.63	0.85	1.11	1.10
New Zealand	3.08	2.87	3.24	3.97	4.52	5.09
Pakistan	0.21	0.23	n/a	n/a	n/a	n/a
Singapore	0.77	0.77	0.82	0.94	1.09	n/a
Tawian	0.48	0.56	0.66	0.80	1.01	1.25

Source: Unpublished Statistics Prepared by U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, March 1981.

This disparity is confirmed by comparing the portion of the total price of manufactured goods represented by labor costs. Table II sets forth the percentage of the total price of manufactured goods represented by payroll in nine industrialized countries. As that table shows, the

TABLE II

A

COMPENSATION AS A PERCENTAGE OF MARKET PRICE * OF MANUFACTURED GOODS

(1978)

Country	Percentage
United States	71.4
Japan	55.7
France	46.8
Germany	59.5
Belgium	65.3

B

COMPENSATION AS A PERCENTAGE OF FACTOR COST ** OF MANUFACTURED GOODS

(1978)

Country	Percentage
United States	75.2
Canada	69.1
Belgium	67.7
Italy	65.2
Sweden	83.0
United Kingdom	76.4

Source: Unpublished data prepared by the U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, May 1981.

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* The market price is the cost of manufactured goods, excluding government subsidies.

** The factor cost is the cost of manufactured goods, excluding indirect taxes, such as sales taxes, but including value added tax.

portion of the total price of a manufactured item represented by labor costs varies substantially from country to country, and for most countries the portion of total cost represented by labor cost is much lower than it is in the United States. Accordingly, the use of the payroll factor to apportion the income of multinational corporations necessarily malapportions income, taking for the taxing jurisdiction that has higher labor costs (here California) an inordinate share of such income.[3]

The misapportionment caused by the application of the three factor formula to combined worldwide net income is also shown by evidence of the higher profitability of foreign investments. At the trial Appellant's expert, Professor John McDonald of Stanford University, gave unchallenged testimony that corporations considering investments abroad will demand a higher expected rate of return ("hurdle rate") than they will demand for U.S. investments, because of the higher risks—principally political—associated with international ventures. Reporters' Transcript ("R.T.") pp. 12-18. He also testified that foreign investments tended, in fact, to produce a higher actual rate of return. R.T. pp. 23-25.[4] This gen-

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[3] The relatively higher ratio of payroll to sales was noted by Donald C. Lubick, then Assistant Secretary of the Treasury for Tax Policy:

> . . . [I]n the United States we may tend to have payrolls as a larger ratio of sales in the conduct of business than in many other jurisdictions. That means that the weighting of payrolls in the United States to total payrolls is going to allocate more income to a particular jurisdiction.

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 4 (1980) (Statement of Donald C. Lubick).

[4] These conclusions, while not challenged, were given as matters of expert opinion. The specific company by company data are considered confidential, *e.g.*, "these 'Hurdle Rates' are regarded by the companies that I know as proprietary information. The sort of thing they don't generally like to reveal to competitors, and they don't like generally to reveal this in their financial statements. . . ." R.T. p. 14.

eral higher profitability of foreign operations, again, rebuts on the world scale the assumptions of uniformity which make the three factor apportionment formula reasonable (and thus constitutionally permissible) as applied to the income of domestic companies.[5]

2. *Commerce Clause.* California's three factor apportionment system as applied to combined worldwide net income also offends the Commerce Clause because it leads ineluctably to multiple taxation of multinational corporations and "impair[s] . . . federal uniformity in an area where federal uniformity is essential." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434.

a. *Multiple Taxation.* In *Japan Line, supra*, the Court considered Los Angeles' *ad valorum* tax on containers temporarily located in the County, but belonging to Japanese container ships. Because the tax was imposed on property having a substantial nexus with the County and fairly was apportioned, it would have been permissible if applied to instrumentalities of interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274. Nonetheless, the Court held that, because the prop-

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[5] The misallocation of income resulting from an erroneous assumption of uniform profitability was emphasized by Joseph H. Guttentag, on behalf of the Dutch Employers' Federation:

> "[P]olitical and economic risks of investment are substantially higher in foreign countries than they are in the United States. These higher risks of investment are reflected in higher rates of profitability in those countries. Because the worldwide combination formula assumes away the existence of these very real differences in profitability, it overstates 'instate' income and leads to state taxation of foreign source profits, which bear no relation to any business risk incurred in the taxing state, as if they had been earned there.

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 314 (1980) (Statement of Joseph H. Guttentag).

erty sought to be taxed were instrumentalities of *foreign* commerce, the tax offended the Commerce Clause:

> When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in *Complete Auto*, come into play. The first is the enhanced risk of multiple taxation.
>
> • • • •
>
> Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. [footnote omitted] [441 U.S. at 446, 448].

The risks of multiple taxation, deemed acceptable in a domestic context (*Moorman Mfg. Co. v. Bair, supra*), are unacceptable in the international arena:

> Even a slight overlapping of tax—a problem that might be deemed *de minimus* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned [441 U.S. at 456].

Los Angeles' *ad valorum* tax created risks of multiple taxation even though it was fairly apportioned:

> . . . [W]hereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," *Washington Revenue Dept.*, 435 U.S. at 746-747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Evco v. Jones*, 409 U.S. at 94, quoting *J.D. Adams Mfg. Co.*, 304 U.S. at 311. [441 U.S. at 447-448.]

The concerns expressed in *Japan Lines* have not abated with the decision of *Mobil Oil Corporation v. Commissioner of Taxes, supra.* The issue of multiple taxation was stipulated out of the case by Mobil:

> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. [445 U.S. at 447.]

The risks of multiple taxation created by the three factor apportionment system as applied to combined worldwide income are as great as those found in *Japan Line.* There the Court noted that the property in question was "owned, based, and registered in Japan . . . Under these circumstances, Japan has the right and the power to tax the containers in full." 441 U.S. at 451-452. Similarly, foreign subsidiaries of the U.S. companies domiciled abroad can be and are taxed on their income produced in those countries, usually as calculated on a separate accounting basis. As noted above, the three factor apportionment system attributes to California substantial amounts of income produced in foreign countries, and reported as income to those host countries. The inevitable result is double taxation.

b. *Interference with Foreign Commercial Policy.* In *Japan Line, supra,* the Court expressed a second concern peculiar to foreign commerce:

> [A] state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern. [441 U.S. at 448].

The Court perceived the need for " 'speaking with one voice' in regulating foreign commerce" to be both a constitutional requirement and a practical necessity. 441 U.S. at 451. While Congress' authority to regulate both interstate and foreign commerce is found in the same clause of

the Constitution, "there is evidence the Founders intended the scope of the foreign commerce power to be greater. [footnote omitted]." 441 U.S. at 448. The practical necessity arises from a likelihood of international retaliation, which would be aimed at the entire Nation, not merely the offending state:

> If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taking State, so that the Nation as a whole would suffer. [footnote omitted] [441 U.S. at 450]

California's three factor formula as applied to foreign commerce is contrary to national and international policy and poses a distinct threat of retaliation.

The national and international effort to rationalize taxation among sovereign states is principally revealed in the U.S. tax laws and in our tax treaties with other nations. Under federal tax law, U.S. companies conducting business through foreign subsidiaries are not taxed by the United States on the earnings of their foreign subsidiaries, as calculated on a separate accounting basis. Federal taxes are imposed on such earnings only when they are repatriated as dividends to the U.S. parent; taxes on such "foreign source income" are subject to an offset for foreign taxes paid. 26 U.S.C. 901-908. This same separate accounting approach—as opposed to apportionment to combined worldwide income—is the basis of our Tax Treaties in force;* is considered the "internationally

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* Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

accepted norm"; [7] and is embodied in the model convention proposed by the OECD (Organization for Economic Cooperation and Development), of which the United States is a member.[8]

Conversely, the practice of formulaic apportionment of combined worldwide income "has created, and continues to create, an irritant in the international relations of the United States. . ." [9] Such an irritant creates a potential for retaliation anticipated in *Japan Line*. This potential for retaliation is well illustrated by the United States' own reaction in the 1930's to extraterritorial taxation by France. France imposed a tax on dividends paid by a U.S. parent corporation with French subsidiaries "in the proportion that its assets in France bore to total assets." [10] When France vacillated on ratification of a treaty to resolve the problem, Congress enacted section 103 of the Revenue Act of 1934.[11] Now section 891 of the 1954 Code, that provision allows the President to double the U.S. tax rate for citizens or corporations of countries that impose discriminatory or extraterritorial taxes on U.S. citizens or corporations. Our own reaction to extraterritorial taxation only serves

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[7] *Ibid.*

[8] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 301 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[9] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 301 p. 7 (1980) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

[10] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 297 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[11] *Ibid.*

to confirm the concern over international retaliation expressed by this Court in *Japan Line*.

CONCLUSION

In sum, the California three-factor apportionment formula, as applied to combined worldwide income, projects the state's taxing authority extraterritorially, doubly taxes foreign income, and disturbs international relations. In each of these, it violates both the Due Process and Commerce Clauses.

For these reasons, jurisdiction of this appeal should be noted.

Respectfully submitted,

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In the Supreme Court
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United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

APPELLANT'S BRIEF ON THE MERITS

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APPELLANT'S BRIEF ON THE MERITS

QUESTION PRESENTED

Whether requiring the income of foreign subsidiaries of a United States corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the foreign commerce and due process clauses of the federal constitution, when:

1. The inclusion of the foreign subsidiaries' income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and in double taxation of the foreign subsidiaries' income through misattribution of that income to California; and

2. The apportionment method used by California conflicts with the separate accounting, arm's-length method of allocation, which is an essential component of United States foreign policy; and

3. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries.

TABLE OF CONTENTS

	Page
Question Presented	i
Opinions Below	1
Jurisdiction	1
Constitutional, Statutory and Regulatory Provisions	1
Statement of the Case	2
a. Flow of Goods Between Container and the Foreign Subsidiaries	4
b. Managerial Relationship Between Container and the Foreign Subsidiaries	4
c. Exchange of Technology	5
d. Exchange of Personnel	6
e. Loans	6
f. Centralized Services	7
Introduction and Summary of Argument	8
Argument	11
I	
Worldwide Apportionment Violates the Due Process Clause Because It Distorts Income Attribution and Produces Extraterritorial Taxation; It Violates the Commerce Clause Because It Results in Multiple Taxation of Foreign Source Income and Prevents the Federal Government from Speaking With One Voice in Regard to Foreign Policy	11
A. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Earned in Foreign Countries	11
1. Container's foreign subsidiaries, and foreign subsidiaries in general, operate in countries with an average wage rate significantly lower than that of the United States	12

TABLE OF CONTENTS

Page

2. Container's foreign subsidiaries, and foreign subsidiaries in general, operate at a substantially higher rate of profitability than Container itself 14

3. Because combined apportionment on a worldwide basis fails to account for the lower wage rates and greater profitability of foreign operations, such apportionment results in the extraterritorial taxation of income earned in foreign countries 15

a. Comparison of Container's Earnings Calculated by Separate Accounting and by Apportionment 16

b. Differences in Profitability Vis-a-Vis Factors 18

B. By Taxing Income Which Was Earned in Foreign Countries, and Not in California, California's Apportionment Violates the Due Process Clause 19

C. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Also Taxed by Foreign Countries, Thereby Violating the Commerce Clause 21

D. California's Tax Prevents the Federal Government from Speaking with One Voice in Regard to Foreign Policy, Thereby Violating the Commerce Clause 27

1. The Federal Tax System Is Based upon Separate Accounting, Deferral of Recognition of Income, and Sourcing of Income with Regard to Foreign Subsidiaries 29

2. The Income Tax Treaties of the United States Implement Federal Policy 30

TABLE OF CONTENTS

Page

3. The Worldwide Unitary Combined Reporting System, Which Imposes an Entirely Different Method of Apportioning Income upon Multinational Corporate Groups, Is in Irreconcilable Conflict with the Federal System 32

E. The Analysis Contained in the Solicitor General *Amicus* Memorandum in *Chicago Bridge & Iron* Requires Reversal of the Judgment Below 36

II

Because There Is No Substantial Operational Interdependence Between Container and Its Foreign Subsidiaries, the Due Process Clause Prohibits the Taxation of Container and the Foreign Subsidiaries as a Single Unitary Business, Regardless of Whether or Not Worldwide Formula Apportionment in General Is Permissible 40

Conclusion 49

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Page

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Table of Authorities Cited

Cases

Page

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State:

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Commerce Clause, Art. I, § 8, cl. 3 1

Fourteenth Amendment, § 1 1

Statutes and Regulations

22 U.S.C. Section 2351(a) 28

22 U.S.C. Section 2351(b)(3) 28

28 U.S.C. Section 1257(2) 1

I.R.C. Section 482 30

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Table of Authorities Cited

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	Page
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Page

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Page

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United Nations Model Taxation Convention Between Developed and Developing Countries, 1 Tax Treaties (CCH) ¶ 171 31

United States Model Income Tax Treaty (1981) 1 Tax Treaties (CCH) ¶ 158 31

OPINIONS BELOW

The opinion of the California Court of Appeal is reported at 117 Cal.App.3d 988, 173 Cal.Rptr. 121 (1981). The memorandum opinion and judgment of the California Superior Court are not reported. Complete texts are set forth as appendices A and B respectively to Appellant's Jurisdictional Statement ("J.S.") at A-1 and A-27.

JURISDICTION

The Court of Appeal rendered its opinion and judgment on April 14, 1981, affirming the California trial court's judgment. Appellant's petition for rehearing was filed April 29, 1981, and was denied by the Court of Appeal on May 4, 1981 (Appendix D, J.S. at A-35). Appellant's petition for hearing in the California Supreme Court was filed May 22, 1981, and was denied June 17, 1981 (Appendix E, J.S. at A-37).

A notice of appeal was filed in the Court of Appeal on July 31, 1981 (Appendix F, J.S. at A-37). The time within which to docket this appeal expired on September 15, 1981, and timely docketing was made. Probable jurisdiction was noted by the Court on May 3, 1982. The time for filing this brief was extended on June 4, 1982 to July 31, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(2).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS

Commerce Clause (Art. I, § 8, cl. 3):

> The Congress shall have power . . . to regulate commerce with foreign Nations and among the several States, and with the Indian Tribes;

Due Process Clause (Amend. XIV, § 1):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law;

California Revenue and Taxation Code, Section 25101 (during the tax years at issue, 1963-1965) provided:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State . . . .

California Administrative Code, title 18, section 25120(b) is set forth in Appendix G to the Jurisdictional Statement.

STATEMENT OF THE CASE

Container Corporation of America ("Container") is a Delaware corporation headquartered in Chicago, Illinois, engaged in the production and distribution of paperboard and paperboard-based packaging. In addition to its operations in the United States, during the years at issue (1963-65), Container owned controlling interests in twenty corporations organized and located in Latin America and Western Europe, the general businesses of which were the same as Container's. The Latin American operations (Colombia, Venezuela and Mexico) accounted for approximately 84% of the subsidiaries' net income. Stipulation of Facts ("Stip.") ¶ 26, Joint Appendix ("J.A.") at 15-16.[1]

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[1]Appellant has relied on the Stipulation of Facts rather than on the lower court's opinion in summarizing the facts because the Court of Appeal misstated facts in a number of instances. For example, the Court of Appeal stated that Container made loans to its subsidiaries totalling over $18 million during the period in question. J.S. at A-4, A-10. However, the Stipulation states only that "the total *loan advances from CCA outstanding at year end* for the years at issue" were $7,704,987 for 1963, $7,155,714 for 1964, and $3,223,371 for 1965. Stip. ¶ 133, J.A. 69-70 (emphasis added). Since any advances which had been made were primarily long-term in

The operations of the foregoing subsidiaries were highly decentralized, so that the subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations. Stip. ¶ 61, J.A. 30. Management of the foreign subsidiaries was comprised predominantly of citizens of the countries involved. Stip. ¶ 74, J.A. 39-40. In most of the Latin American subsidiaries, local investors held substantial minority stock interests (*i.e.*, in Colombia approximately 33% and in Venezuela approximately 20%). In nearly half of the foreign subsidiaries local representatives constituted a majority of the board of directors. Stip. ¶ 25, 78, J.A. 14, 40; Exhibit E to the Stipulation of Facts.

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nature, the advances outstanding at year end far exceeded any advances which may have been made during a particular year. Thus, the Court of Appeal greatly exaggerates the amount of loans from Container to the foreign subsidiaries. Elsewhere, the Court of Appeal gives weight to the unsupported assertion that "the parent corporation was involved with the training of local nationals for management positions." J.S. at A-13. However, the Stipulation states that "there was no United States training program for the foreign subsidiaries' employees." Stip. ¶ 132, J.A. 69. While employees of the foreign subsidiaries occasionally visited United States operations, there is no indication that Container was involved in the training program, or that those managing the foreign subsidiaries were required to make the trips as part of their training.

Other errors typify the lack of care which the Court of Appeal employed in reviewing the facts. Thus, for example, at one point the court states that "all the foreign operations were audited by the same accounting firm that audited appellant's books," J.S. at A-9, but elsewhere acknowledges the true state of affairs, i.e., the subsidiaries in the Netherlands and Germany used their own accounting firms for audits. J.S. at A-4. The opinion also refers to 38 of Container's employees being "assigned" to foreign subsidiaries. J.S. at A-2, A-3. However, the Stipulation shows that these 38 individuals were actually employees of the foreign subsidiaries who were carried on Container's payroll as an accommodation to employees in special circumstances. Maintenance of the employees on Container's payroll required little effort, and Container was reimbursed for the service, as well as the payroll costs, by the foreign subsidiaries. Stip. ¶¶ 124-125, J.A. 64-65.

While Container's majority interest in the subsidiaries gave Container the potential for control and domination of the subsidiaries, Container did not dominate the subsidiaries, but instead left management of the businesses and control over business decisions to the subsidiaries. Stip. ¶¶ 74, 130, J.A. 39-40, 67-8. Especially within the developing countries (Colombia, Mexico, and Venezuela), prudence dictated that high profile participation by United States personnel in the local business be kept to a minimum. Stip. ¶¶ 27, 62, 130 J.A. 16, 30-31, 67-68.

(a) Flow of Goods Between Container and the Foreign Subsidiaries

Container purchased no raw materials or finished products from the foreign subsidiaries. Container did not sell any finished products to the foreign subsidiaries and sold only an insignificant amount of unfinished products to the subsidiaries. Stip. ¶¶ 26, 64, 141, 143, J.A. 15-6, 32, 73, 74. In all cases, the prices paid for unfinished products (raw materials and paperboard) were the same as Container would charge other independent purchasers, and in all cases the materials could have been obtained from sources other than Container. Stip. ¶ 141, J.A. 73.

Container and the foreign subsidiaries had no master contract or formal arrangement to make sales to customers located in both the United States and in foreign countries. There were no joint marketing efforts between Container and the foreign subsidiaries, and Container did not solicit sales for its foreign subsidiaries. Stip. ¶ 65, J.A. 32-34.

(b) Managerial Relationship Between Container and the Foreign Subsidiaries

The management of the foreign subsidiaries had complete authority and control over day-to-day business decisions. Such business decisions were not reviewed or subject to review by Container. Major policy matters, defined as consisting exclusively of capital appropriations, were also the responsibility of the foreign subsidiaries, but were

generally subject to review by Container. All other policy matters were the complete responsibility of the foreign subsidiary. Even in matters involving a major capital expenditure, the initiative rested with the foreign subsidiary, and local management reserved the right to forego initiation of previously authorized projects. Stip. ¶74, J.A. 39-49. Each subsidiary had total responsibility for its own performance. Stip. ¶¶ 127, 130, J.A. 65-66, 67-68.

During this period, Container's foreign operations staff, charged with overseeing the 20 foreign subsidiaries, consisted entirely of two full-time operations officers and three individuals, a senior executive officer, a controller, and a lawyer, who devoted part of their time to matters involving Container's investment in the foreign subsidiaries. Stip. ¶ 126, J.A. 65.

(c) Exchange of Technology

Container provided technical assistance to the foreign subsidiaries only in limited instances. For example, the foreign subsidiaries, generally either internally or with the help of independent consultants, developed their own techniques for processing raw material and for adapting machinery to different grades of paperboard. Container offered little material assistance in developing this vital technology. Stip. ¶¶ 76, 84, 85, 146, J.A. 41, 44-5, 45-6, 75-6. Similarly, Container had little or no role in the production of paperboard-based packaging by its subsidiaries, since the functional and graphic designs of the packages which Container manufactured were generally ill-suited to the products and markets served by the foreign subsidiaries. Stip. ¶¶ 56, 57, 67-70, 73, J.A. 27-8, 35-7, 39. In any event, in those instances where Container provided technical assistance to the foreign subsidiaries, the information was paid for unless prohibited by local law. Stip. ¶¶ 66, 144-146, J.A. 34-5, 74-6. Even in instances where Container had useful information, the foreign affiliates often sought assistance from local consultants, not affiliated with Container,

rather than taking advantage of existing technical services agreements with Container. Stip. ¶ 146, J.A. 75-76.

(d) Exchange of Personnel

The personnel departments of the various foreign subsidiaries, except to the limited extent discussed below, were fully independent operations and were expected to recruit and train local nationals to fill positions at every level. Stip. ¶¶ 79, 89, 95, 109, J.A. 42-3, 48, 51, 56. There was no general policy of transferring Container employees to foreign subsidiaries. Stip. ¶ 120, J.A. 62.

The number of employees who actually transferred from Container to a foreign subsidiary, or who were known to have become employed with a foreign subsidiary after having worked for Container, were few. During the period in question, only 26 former Container employees were working for foreign subsidiaries. This figure should be compared with the approximately 13,400 persons employed by Container during the same period and the 6,800 persons employed by foreign subsidiaries during the period. Stip. ¶ 119, J.A. 60-1. During the period in question, 38 employees (which includes all of the 26) of the foreign subsidiaries were also on the payroll of Container, not because of any substantive relationship with Container, but generally as a matter of convenience to employees in special circumstances. Stip. ¶ 124, J.A. 64-65.

(e) Loans

The foreign subsidiaries generally obtained financing from local sources. Stip. ¶ 133, J.A. 69-70. In certain instances, Container acted as guarantor for those loans. However, for the most part, Container had no involvement in the arrangement of such loans.

Container also made some direct loans to its subsidiaries during the period in question. The total balance of advances from Container outstanding at the end of each of the years at issue were as follows:

1963	1964	1965
$7,704,987	$7,155,714	$3,223,371

These figures compare with the following balances of outstanding loans for the foreign subsidiaries at the end of each year:

1963	1964	1965
$18,596,000	$15,497,000	$14,441,000

Stip. ¶ 133, J.A. 69-70.

(f) Centralized Services

There were no significant centralized services performed by the parent for the subsidiaries (or vice versa). The foreign subsidiaries hired their own personnel, operated their own manufacturing facilities, purchased their own supplies, and conducted their own marketing, advertising and accounting. Stip. ¶¶ 66, 88-9, 93, 95, 104, 107, 116-18, J.A. 34-35, 47-48, 50-51, 54-55, 58-59.

In rare instances Container sold used equipment to foreign subsidiaries. Stip. ¶ 147, J.A. 76-7. During the entire period in question, the total amount of such purchases by the foreign subsidiaries was less than $80,000. Exh. A-8, Joint Appendix: Exhibits ("J.A.E.") at 8.

Container also assisted the foreign subsidiaries, mainly those in Latin America, with the purchase of equipment, generally from suppliers located in the United States. In those instances Container acted only as an "independent broker" for the foreign subsidiary, for which it generally charged the subsidiary five percent of the purchase price. Stip. ¶ 148, J.A. 77. Container also acted as a broker in obtaining some waste paper for the subsidiaries. Stip. ¶ 143, J.A. 74.

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During the tax years at issue, Container filed California franchise tax returns and paid franchise tax to California based on an apportioned share of its net income. The income of Container itself was $25,362,000, $28,975,000 and $30,027,000. Over Container's objection, California insisted that the income of the foreign subsidiaries be included in Container's tax base, increasing the tax base to $36,158,000,

$43,055,000 and $45,916,000, respectively. Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-13.

Container commenced this refund action on April 8, 1974, in the Superior Court of the State of California for the City and County of San Francisco. The complaint was based upon, and incorporated, claims for refund previously filed by Container and denied by the California Franchise Tax Board. The claims demanded refunds upon the ground, *inter alia*, that the state is prohibited from including these foreign subsidiaries in a unitary return with Container under the due process and foreign commerce clauses of the Constitution. Container has resisted imposition of the tax on the grounds that California's method of taxation, on its face and as applied to the instant facts, is repugnant to the foreign commerce and due process clauses of the Constitution. Both the Superior Court and the California Court of Appeal refused to grant relief from the due process and foreign commerce clause violations. The opinions of these courts are attached to the Jurisdictional Statement as Appendices A and B. The California Supreme Court denied a petition for hearing on June 17, 1981.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case, together with the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., et al.* (No. 81-349), represents the Court's first occasion to consider the constitutional issues arising from the application of combined apportionment to a corporation and its foreign subsidiaries on a worldwide basis.[2] An examination of these issues

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[2] *Bass, Ratcliff & Gretton Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), has no bearing on the question presented herein. That case involved an English corporation which brewed ale in England and sold it in the United States. Significantly, no question concerning a subsidiary was present because all operations were conducted by a single corporate taxpayer. Moreover, the taxpayer adduced no proof of misattribution of income to New York, the taxing state, in

(footnote continued)

reveals that California's system of unitary apportionment on a combined, worldwide basis violates the due process and commerce clauses of the United States Constitution, both inherently and as applied to the facts of this case.

Application of worldwide unitary combination to multinational corporate groups fails to meet constitutional standards in three broad areas. First, the apportionment formula frequently (including in this case) misapportions income to the United States members of the group, resulting in extraterritorial taxation in violation of the due process clause. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317 (1968); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). Second, because the income misapportioned to the United States members of the group is fully taxed in the foreign country where it was earned, the income is subject to double taxation, in violation of the commerce clause. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). Finally, the inconsistency of worldwide apportionment with the separate accounting, arm's-length method used by the United States and by foreign governments results in double taxation which impairs the ability of the United States to speak with one voice in carrying out its foreign policy, thereby violating the commerce clause. *Japan Line, Ltd. v. County of Los Angeles; Zschernig v. Miller*, 389 U.S. 429 (1968).

Any one of these three constitutional violations, in and of itself, requires invalidation of worldwide combination, both as a general matter and as applied to the facts of this case. The issues of distortion, double taxation and im-

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contrast to the clear showing of distortion made in the present case. Finally, the *Bass* case was decided almost sixty years ago, before the advent of the United States tax treaty network and before development of the separate accounting, arm's-length method as a part of United States foreign policy.

pairment of federal policy are addressed in the present case in Part I of this brief.

In addition to the three constitutional problems described in the preceding paragraphs, California is prohibited from applying combined apportionment in this case because Container and its foreign subsidiaries are not parts of a single unitary business. This fact alone also prohibits combined apportionment.

The three cases in which the Court has recently considered the constitutional implications of state taxation of foreign source income (in the context of dividends from foreign subsidiaries), relate only to the unitary business issue in this case. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *ASARCO, Inc. v. Idaho State Tax Comm.*, ... U.S. .....; 50 U.S.L.W. 4962 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dept.* ..... U.S. .....; 50 U.S.L.W. 4957 (1982). In *Mobil*, the Court approved state taxation of foreign dividends as a part of the recipient's apportionable income, only because the Court assumed that the payor subsidiaries were unitary with Mobil. Furthermore, Mobil did not introduce evidence of distortion in the apportionment formula.

In *ASARCO* and *Woolworth*, the Court prohibited state taxation of foreign dividends as part of apportionable income of the parent corporation on the ground that the subsidiaries were not part of a unitary business with the parent. The Court's opinions on the unitary issue in these two cases, especially *Woolworth*, which is strikingly similar to *Container* on the facts, are controlling precedents here and require a holding that Container and its subsidiaries are not unitary. This issue is discussed in Part II of the brief.

ARGUMENT

I

WORLDWIDE APPORTIONMENT VIOLATES THE DUE PROCESS CLAUSE BECAUSE IT DISTORTS INCOME ATTRIBUTION AND PRODUCES EXTRATERRITORIAL TAXATION; IT VIOLATES THE COMMERCE CLAUSE BECAUSE IT RESULTS IN MULTIPLE TAXATION OF FOREIGN SOURCE INCOME AND PREVENTS THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE IN REGARD TO FOREIGN POLICY

A. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Earned in Foreign Countries

California, through its system of worldwide unitary combination, has misallocated a substantial amount of unrepatriated foreign income, not earned in California, to California's income tax base. This misallocation occurs because the basic assumption underlying unitary combination breaks down when that system is applied to foreign operations. As a result, unitary combination, when applied on a worldwide basis, generally produces extraterritorial taxation that is unconstitutional under the due process clause.

Container itself operates entirely within the United States. Each subsidiary of Container operates entirely within a foreign country. Combined apportionment under the unitary method assumes that a dollar of property, payroll or sales of the parent (Container) produces approximately the same amount of income as a dollar of property, payroll or sales of a subsidiary. Hellerstein and Hellerstein, *State and Local Taxation*, 539 (4th ed. 1978). However, as demonstrated below, Container's principal foreign subsidiaries (and foreign operations in general) produce a greater amount of income per dollar of property, payroll and sales than the parent's United States operations. This difference in profitability is compounded by the fact that the subsidiaries operate in foreign countries where wage rates are substantially lower.

Because California's apportionment on a worldwide, combined basis necessarily ignores differences in payroll costs or profitability, it apportions income earned by the companies with lower payroll and/or greater profitability (here, the foreign subsidiaries) to the tax base of companies with higher payroll and/or lesser profitability (here, Container). Thus, the remainder of this subsection will set forth various data comparing wage rates, productivity and profitability in the United States with the foreign countries where Container's subsidiaries operate. This data forms the basis for the separate arguments made below in subsections B (distortion), C (double taxation) and D (impairment of the ability of the United States to speak with one voice in regard to foreign policy).

1. Container's foreign subsidiaries, and foreign subsidiaries in general, operate in countries with an average wage rate significantly lower than that of the United States

The costs of production in foreign countries are generally significantly lower than in the United States, primarily as a result of the lower wage rates of workers in countries other than the United States. Because wages are one of the three factors used in formulary apportionment, the use of the formula unfairly inflates the amount of income apportioned to United States operations, where wages are higher.

Although the wage rates in several of the more advanced industrial countries are, in recent years, approaching, and in some cases exceeding, those in the United States, nevertheless wage rates in the less industrialized countries remain well below those in this country. In Appendix A, at A-1, comparative wage rates compiled from United Nations sources for the years 1963-1965 show wages for underdeveloped countries at ranges between 10% and 30% of United States wages. United Nations statistics for the years 1974-1980, in Appendix B at A-3, show that while wages throughout the world are increasing, the same disparity between wages paid United States workers and those

in less industrialized countries continues to exist. Furthermore, as the United States Tariff Commission has demonstrated (see Appendix C at A-5), these differences in wage rates are not offset by lower levels of productivity for workers in various economic settings. These studies are corroborated by other sources.[3]

Container's own experience also confirms these findings. A study by Container relating to production of corrugated containers shows that the differences in productivity for 1974 were as follows:

	Cali, Colombia	All California Plants
Labor Cost per thousand square feet	$1.19	$2.85

Sch. II to Exh. 1, Stip. re Testimony, J.A. 105.

As this study demonstrates, workers in California are paid almost two and a half times the amount paid to workers in Colombia to produce the same quantity of corrugated containers. To the extent the payroll factor in Colombia consists of the wages paid to such workers, the distortion will lead directly to a misapportionment of net income. As demonstrated below, less dramatic, but similar, results occur with regard to the sales factor.

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[3]As stated in Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies," 44 *J. Tax* 184, 187 (1976):

> . . . wage levels are considerably lower in Japan, Italy or almost any other country than in the United States for the same work. In 1969, the cost of engineering work in Japan was only 70% of that in the U.S. (England was 75%, Holland 80%, France 90%). . . .
>
> The same type of disparity exists as to the cost of plant or property. For example, . . . in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U.S. was $137,000, while an average of only $58,000 was required outside the U.S.
>
> An apportionment of worldwide income based on property and payroll could never, under these circumstances, properly apportion the income to the local activities which produced it.

Because California's apportionment formula, as applied to the combined report, attributes income in major part (one third) upon the basis of payroll costs, the variations in wage levels have produced a substantial misapportionment of income toward California, which has the higher wage rates.

2. Container's foreign subsidiaries, and foreign subsidiaries in general, operate at a substantially higher rate of profitability than Container itself

On the average, the rate of profitability of Container's subsidiaries, particularly those in Colombia and Venezuela, is substantially higher than that of Container in the United States. Thus, Container's net income as a percentage of sales in the United States for 1963 through 1965 averaged 9.43%, while Colombia averaged 20.30% and Venezuela 22.95%. Container's net income as a percentage of invested capital averaged 13.11%, Colombia 20.51%, and Venezuela 31.56%. Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-13.

The uncontroverted testimony of Container's expert witness, Professor John C. McDonald of Stanford, confirms that because of the greater profitability of the foreign subsidiaries, the basic premise of apportionment on a combined basis breaks down when applied to foreign operations. As Professor McDonald stated, an individual U.S. company will invariably require a higher "hurdle rate" (*i.e.*, minimum anticipated rate of return on investment) for a foreign investment than for a similar domestic investment. Thus, companies expect to receive a greater rate of return on a foreign investment than on a similar domestic investment. Generally, this greater rate of return is achieved. The reasons for this include lower labor costs, more rapidly expanding economies, greater market share, governmental protection from competition, etc. J.A. 131-144, 154-167. Professor McDonald also testified that Container's "hurdle rate" and rate of profitability for its foreign subsidiaries were typical of foreign operations in general. J.A. 175-76, 186-7.

3. Because combined apportionment on a worldwide basis fails to account for the lower wage rates and greater profitability of foreign operations, such apportionment results in the extraterritorial taxation of income earned in foreign countries

Formula apportionment, when applied to the worldwide income of Container and affiliates, attributes far more income to the domestic operations of Container than Container reported for federal income tax purposes by applying the arm's-length method of accounting prescribed by the Internal Revenue Code and adopted by the international community. Correspondingly, this apportionment attributes far less income to the foreign operations of Container's subsidiaries than was earned, reported and taxed in the foreign countries in which the subsidiaries operate. This results in California's taxation of income earned not in the state, but in foreign countries.

Formula apportionment fails to recognize the variations in profitability between corporations. The profit of the total group is apportioned among the members of the unitary group according to the factors used in the formula (in California, property, payroll and sales). If the factors of the various members are approximately equal, the formula will apportion the income about equally among the members, even if actual incomes are not equal.[4]

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[4]For example, if two corporations, one doing business exclusively in California and the other exclusively in Colombia, are combined and have the same total property, payroll and sales, formula apportionment would apportion one half of the combined income of the two companies to each, even if only one was actually profitable. Thus, even if the Colombian corporation earned $100,000 and the California corporation lost $30,000, California's apportionment on a combined basis would attribute $35,000 of income to each. Misattribution of income has also occurred in the present case, principally between Container and its Latin American subsidiaries.

(a) Comparison of Container's Earnings Calculated by Separate Accounting and by Apportionment

The magnitude of misattribution wrought by apportionment on a combined, worldwide basis can be demonstrated by comparing the income of Container from its domestic operations, as reported to the Internal Revenue Service, to the amount of income attributed to those operations by California's formula. That is to say, if one applied the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being worldwide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by worldwide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:[5]

1963	1964	1965
$2,407,000	$3,996,000	$5,466,000

That leads, in turn, to an apportionment of income to California which is greater than when the base income used is domestic only, rather than worldwide. The increase in California income from the use of worldwide apportionment over the income produced by apportionment of domestic income can be shown as follows:

	1963	1964	1965
1. World-wide income apportioned to California	$3,141,635	$3,579,413	$3,523,222
2. Domestic income apportioned to California	$2,888,547	$3,139,629	$2,947,125
3. Increase of 1 over 2	$ 253,008	$ 439,784	$ 576,097

This misattribution is confirmed by a comparison of the income attributed to the various countries under a separate accounting, arm's-length analysis with that assigned

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[5]Exhibit A to the Stipulation of Facts, J.A.E. 1-8, contains the basic data used in the calculations to prepare the following two tables.

to the countries by the use of California's apportionment formula:[6]

	Average Pre-Tax Income per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
Container (United States)	$28,121,000	$32,068,000
Colombia	4,254,000	2,203,000
Mexico	1,605,000	1,430,000
Venezuela	4,246,000	1,907,000
Panama	1,286,000	—
Austria	(13,000)	11,000
Germany	1,793,000	2,906,000
Holland	384,000	197,000
Italy	34,000	968,000
Total Foreign	13,588,000	9,642,000
Total Combined	$41,710,000	$41,710,000

Thus, California's formula attributes an average of $4 million per year more to United States operations (and $4 million per year less to foreign operations) than the method of accounting used by the United States and the major trading countries in the world.

As the above table illustrates, the distortion produced by the formula is particularly acute between the underdeveloped and the highly-industrialized countries. For example, the apportionment formula attributes to other countries approximately one half of the income produced in Colombia and Venezuela according to the arm's-length principles applied in those countries. In Colombia's case, this produces the ludicrous result of apportioning little more pretax income to Colombia (and in some years less) than the Colombian subsidiaries paid in Colombian income taxes. The income attributed to Colombia by the California formula for the years in question is, respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be

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[6]Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-113. This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal. 3d 745, 91 Cal. Rptr. 616, 478 P.2d 48 (1970).

$2,508,036, $2,533,755, and $1,484,104, respectively. Second Addendum to Stip. ¶ 159, J.A. 83-84.

As a further example, by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of an average income of $384,000 per year. Actual taxes paid to the Dutch government averaged 97% of income attributed to Holland by the formula. *Id.*

(b) Differences in Profitability Vis-a-Vis Factors

The record also demonstrates the difference in the relationship between the factors and the net income produced in various countries in which Container and its subsidiaries operate throughout the world. That data is summarized in the following table which compares the relationship between dollars of sales, of payroll and of property required to produce $1.00 of net income computed for Container domestically and for Container's foreign subsidiaries in each particular country.[7]

Amount Required to Produce $1.00 of Net Income
For the Years 1963-65

Country	Payroll	Sales	Property
United States	$3.34	$10.65	$4.83
Colombia	0.27	5.17	4.74
Mexico	1.53	10.69	6.29
Venezuela	0.81	4.73	3.40
Germany	3.95	17.62	9.73
Netherlands	0.96	7.98	1.59

As can be seen from this table, the distortion in the apportionment of Container's income can be traced primarily to a dramatic difference in the relationship of payroll cost to net income in the United States as compared to other countries and to a lesser extent to a difference in the relationship of sales to net income.

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[7]Italy is not included because the data is incomplete and because one of the Italian units was sold in 1964. These figures are derived by dividing the net income produced in each country by the respective sales, payroll, and property factors for that country. Exh. A1-8, J.A.E. 1-8, contain the basic data used to prepare this table.

B. By Taxing Income Which Was Earned in Foreign Countries, and Not in California, California's Apportionment Violates the Due Process Clause

As noted above, the primary reason that the three-factor payroll, property and sales formula is an acceptable method of dividing the taxable income of multistate enterprises among the states is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized in one state, typically produce roughly the same amount of income as a dollar spent or sales made in other states. To be sure, it is recognized that there are state-by-state variations in wage and property costs that produce imprecision in apportionment, but these differences fall within the area of constitutional tolerance for "rough approximation" in the division of income from operations within the United States. *International Harvester Co. v. Evatt*, 329 U.S. 416, 422 (1947).

However, when apportionment is extended to foreign countries, wages, property costs and profits on sales vary so dramatically that the premise is no longer viable. Instead of producing a fair approximation of income earned in California, the apportionment formula results in taxation of income earned outside the state. Hence, the attempted extension of the three-factor formula beyond the borders of the United States violates the due process clause because it is "inherently arbitrary" and produces "an unreasonable result." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920); see also *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Wallace v. Hines*, 253 U.S. 66 (1920).

Even if the California apportionment formula produced a reasonable result in apportioning income between foreign and domestic operations of another taxpayer, the formula cannot be sustained here because of the substantial misattribution of income which results. As stated in *Norfolk &*

Western Railway Co. v. Missouri State Tax Commission, 390 U.S. 317, 327 (1968):

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most circumstances, may produce a tolerable product.

The facts in many cases,[8] including this one, demonstrate that the formula leads to an unacceptable level of distortion so as to violate the due process and commerce clauses. We urge the Court to reiterate its conclusion in *Norfolk*, where, in the context of distortion resulting from the formula used by Missouri to value railroad rolling stock for property tax purposes, the Court stated as follows:

> We repeat that it is not necessary that a State demonstrate that its use of the mileage formula has resulted in an exact measure of value. But when a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail.

Id. at 329. California has not and, as shown above, cannot carry such a burden. Thus, California cannot apportion the income of Container on a combined, worldwide basis.

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[8] *See*, G.A.O., *Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* at 32 (1982) (hereinafter "G.A.O. Report").

C. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Also Taxed by Foreign Countries, Thereby Violating the Commerce Clause

As demonstrated above, California's system of worldwide combination apportions to California income which, under the separate accounting system adopted by the Internal Revenue Code, was earned in foreign countries. However, it is not only the separate accounting system as applied by the United States government which demonstrates that California is attempting to tax income earned in foreign countries. Rather, this same separate accounting system is used to allocate and tax income by all the foreign countries in which Container's subsidiaries operate (and, in fact, by the major trading countries of the world). As a result, California is not only taxing income which has been *earned* in foreign countries under the system of allocation applied in those countries, California is taxing income which is, in fact, also *taxed* by the foreign countries in which Container's subsidiaries operate. The resulting multiple taxation of the same income subjects foreign commerce to a burden which is not borne by intrastate commerce and is prohibited by the commerce clause. *Erco v. Jones*, 409 U.S. 91 (1972); *Western Live Stock Co. v. Bureau of Revenue*, 303 U.S. 250 (1938); *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).[9]

As the table set forth at page 17 illustrates, an average of approximately $4 million in income per year, which was taxed on a separate accounting basis in foreign countries, is apportioned to the United States, where it is

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[9]Subsections C and D of this section of the brief show how use of worldwide unitary combination results in international double taxation and prevents the United States from "speaking with one voice when regulating commercial relations with foreign governments." As the court said in *Japan Line*, "If the state contravenes *either* of these precepts, it is unconstitutional under the Commerce Clause." 441 U.S. at 451 (emphasis added).

subject to tax again by the California formula. Some of the $4 million was actually taxed by California (Container's average California factors are approximately 10% of the total United States factors, so approximately 10% of the average income shifted to the United States was taxed by California).

More importantly, under California's theory, all of the approximately $4 million per year is subject to being taxed a second time by some state. In fact, 12 other states now use a system of apportionment almost identical to California's,[10] so that these states could also impose a multiple tax burden on the income of Container's foreign subsidiaries. Thus, the total cumulative impact of California's method of apportionment must be considered in addition to the multiple burden imposed by California itself. As Justice Stone stated in his landmark opinion setting forth the multiple taxation doctrine:

> The vice characteristic of those [taxes] which have been held invalid is that they have placed on the commerce burdens of such a nature as to be capable, in point of substance, of being imposed . . . or added to . . . with equal right by every state which the commerce touches, merely because interstate commerce is being done, so that without the protection of the commerce clause it would bear cumulative burdens not imposed on local commerce.

Western Live Stock v. Bureau of Revenue, 303 U.S. at 255-56 (citations omitted).

The multiple burdens resulting from California's apportionment formula are also illustrated by the fact that the apportionment formula attributes to other countries (principally the United States) approximately one half of the income produced in Colombia and Venezuela according to

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[10]The thirteen states imposing worldwide combination are: Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah. *See* G.A.O. Report at 31.

the arm's-length principles actually applied in those countries. As noted above, in Colombia's case, this produces the ludicrous result of apportioning little more pretax income to Colombia (and in some years less) than the Colombian subsidiaries paid in Colombian income taxes. Also as noted above, the actual taxes paid by Container's Dutch subsidiary to the Dutch government average 97% of the income attributed to Holland by the California formula. Thus, the income of the Colombian and Dutch subsidiaries has been taxed twice—once fully in Colombia or Holland and once again in California. This is also true of the Venezuelan and Mexican subsidiaries. Second Addendum to Stip. ¶ 159, J.A. 83-84.

In the case of foreign commerce, this Court has noted an "enhanced risk of multiple taxation" which demands that state taxes be reviewed with an especially high level of scrutiny. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 446-48 (1979). In *Japan Line,* the Court explained the reasons why multiple taxation resulting from differing allocation and apportionment methods may be constitutionally tolerable in dealing with state taxation of interstate commerce, but is not tolerable in dealing with state taxation of foreign commerce. In invalidating the tax, the Court stated:

> The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies.
>
> Yet neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur,"

> *Washington Revenue Dept.*, 435 U.S., at 746-747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." *Evco v. Jones*, 409 U.S., at 94, quoting *J. D. Adams Mfg. Co.*, 304 U.S. at 311.

441 U.S. at 447-48 (footnote omitted).

The Court's discussion of *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) further illustrates this point:

> [*Japan Line*], by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist and cannot be policed by this Court at all. *Moorman*, finally, concerned interstate commerce. This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.

441 U.S. at 455-56 (footnote omitted).

In other words, the Court can assure fair apportionment in interstate commerce (thus preventing imposition of multiple tax burdens) because the Court has the power to review the formulas of all the jurisdictions levying a tax. Where apportionment formulas conflict, the Court can determine whether any one formula is "to blame," and invalidate the unfair formula. In foreign commerce, however, no tribunal exists to ensure that income earned in foreign commerce is taxed in the aggregate only once. Thus a state's apportionment method, even if (unlike here) a fair one, may subject foreign commerce " 'to the risk of

a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." 441 U.S. at 448.

It is clear that in this case California's apportionment must yield to the allocation made by the foreign countries in which Container's subsidiaries operate, regardless of whether a state's apportionment must *always* yield to the allocation made by a foreign government. *Japan Line* indicates that at the very least a state's formula must yield when it either results in the imposition of a multiple tax burden on foreign commerce, or the state's formula, as California's formula here and as the formula invalidated in *Japan Line*, is contrary to the custom of nations and the policy of the federal government. "California's tax . . . must be evaluated in the realistic framework of the custom of nations." 441 U.S. at 454. The foreign nations in which the subsidiaries of Container do business have the right and the power to tax the income of these subsidiaries on an arm's-length, separate accounting basis, and do so.[11] Because this taxation is consistent

[11]Container's foreign subsidiaries filed their income tax returns on a separate accounting basis. Stip. ¶ 140, J.A. 72. This method of determining the income of those subsidiaries for income tax purposes is in accordance with the laws of their respective countries as in effect during the years in issue. *See generally* Arthur Andersen & Co., *Tax and Trade Guide—Colombia*, 49-112 (1965); Arthur Andersen & Co., *Tax and Trade Guide—Italy*, 47-105 (1962); Arthur Andersen & Co., *Tax and Trade Guide—Germany*, 15-63 (1964); Arthur Andersen & Co., *Tax and Trade Guide—Mexico*, 27-75 (1967); Arthur Andersen & Co., *Tax and Trade Guide—The Netherlands*, 23-69 (1965); Arthur Andersen & Co., *Tax and Trade Guide—Venezuela*, 21-75 (1966); Board of Inland Revenue, 3 *Income Taxes Outside the United Kingdom*, 129-59 (1967) (Germany); Board of Inland Revenue, 5 *Income Taxes Outside the United Kingdom*, 213-17 (1967) (The Netherlands); Harvard University, *World Tax Series—Taxation in Colombia*, 218-36, 240-45, 335-6 (1964); Harvard University, *World Tax Series—Taxation in Italy*, 335, 354-89, 395-401 (1964); Harvard University, *World Tax Series—Taxation in Mexico*, 119-30, 139-58 (1957); Harvard University, *World Tax Series—Taxation in the Federal Republic of Germany*, 830, 2208-14, 2255-63 (1969); International Bureau of

with the custom of nations and foreign policy, California's contrary apportionment method cannot be upheld.

In *Japan Line* the Court prohibited California from taxing the containers on an apportioned basis because of the resulting double taxation of foreign commerce which the Court had no authority to limit, and because the California tax would impair the conduct of the Nation's foreign policy. Appellant submits that California is likewise prohibited from taxing the income of the foreign subsidiaries on an apportioned basis, a basis contrary to the established custom of nations, because of the resulting double taxation which this Court cannot ameliorate and because the California tax again would impair federal policy.

In short, California's use of worldwide combination on a unitary basis results in the imposition of a double tax burden on foreign commerce to which domestic commerce is not subjected and which the commerce clause forbids.

Fiscal Documentation, *The Taxation of Companies in Latin America, Venezuela*, C-3 to C-5 (1981); International Bureau of Fiscal Documentation, *The Taxation of Companies in Europe, Netherlands*, 134 (1977).

Reporting income on a separate accounting basis also accords with the tax treaties in effect between the United States and these foreign countries. Convention for the Avoidance of Double Taxation With Respect to Taxes on Income, July 22, 1954, United States—Federal Republic of Germany, art. IV, T.I.A.S. No. 3133; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, March 30, 1955, United States—Italy, art. IV, T.I.A.S. No. 3679; Convention with Respect to Taxes on Income and Certain Other Taxes, April 29, 1948, United States—The Netherlands, art. IV, §§ 1-2, T.I.A.S. No. 1855. Finally, the separate accounting, arm's-length standard is embodied in the current laws of those foreign countries. *See*, Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Colombia* 9-22 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Italy* 1-6, 12-19, 38-48 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Mexico* 65-70, 162-75 (1978); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Netherlands* 1-21 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—West Germany*, 23-59, 62-72 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Venezuela* 8-24 (1979).

D. California's Tax Prevents the Federal Government from Speaking with One Voice in Regard to Foreign Policy, Thereby Violating the Commerce Clause

The Framers of the Constitution clearly recognized that the federal government must have sole power in dealing with foreign nations.

> The *second* class of powers lodged in the General Government consists of those which regulate the intercourse with foreign nations, to wit, to make treaties; . . . to regulate foreign commerce . . . .
>
> This class of powers forms an obvious and essential branch of the federal administration. If we are to be one nation in any respect, it clearly ought to be in respect to other nations.

The Federalist Papers No. 42, at 279 (Madison) (J. Cooke ed. 1961).

The Court has long confirmed the preeminence of the national government in regard to foreign commerce. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933). "[T]he Federal Government must speak with one voice when regulating commercial relations with foreign governments . . . ." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976).[12]

Especially since World War II, it has been the foreign policy of the United States to promote the free international flow of capital and technology to foster the social and economic progress of the United States and other nations of the world.[13] In order to promote this foreign policy

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[12]*See also Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299, 319 (1852); *Zschernig v. Miller*, 389 U.S. 429 (1968).

[13]The current administration has recently reaffirmed the long-established importance to the foreign policy of the United States of efforts to remove impediments to the free flow of trade and investment. *See*, remarks by President Reagan to the World Affairs

(footnote continued)

objective, the United States has developed a series of rules, both in the Internal Revenue Code and in its tax treaties, to provide a coherent allocation system for eliminating double taxation of multinational corporate groups. In this regard, the United States has determined that double taxation is a major impediment to its policy of promoting the free flow of capital and technology. As a United States Treasury official has stated:

> We view tax treaties as an important element in the international economic policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology, and this objective is fostered by having the broadest possible network of income tax treaties.
>
> Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments.
>
> Treaties accomplish this minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory

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Council of Philadelphia, October 15, 1981, excerpted in the *N. Y. Times*, Oct. 16, 1981, § 1, at 12. *See also*, statements by Myer Rashish, Under Secretary of State for Economic Affairs, and Robert D. Hormats, Assistant Secretary of State for Economic Affairs before the Subcommittee on Trade of the H. Ways and Means Comm. on October 29, 1981, printed in *Dep't. St. Bull.*, Dec. 1981, at 44. Further, Congress has declared that it is the policy of the United States "to increase the flow of international trade" and "to encourage the contribution of United States enterprise toward the economic strength of less developed friendly countries through, [*inter alia*] private trade and investment abroad." 22 U.S.C. § 2351(a). To this end the President is directed in 22 U.S.C. § 2351(b)(3) to:

> accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall include provisions to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this chapter.

> tax rules which distinguish unreasonably between domestic and foreign investment.[14]

Because California's method of taxation conflicts with the system set forth in the Internal Revenue Code and in United States treaties, which are used as a basis for implementing United States foreign policy, California's tax "impair[s] federal uniformity in an area where federal uniformity is essential," and hence violates the commerce clause. *Japan Line*, 441 U.S. at 448.

1. The Federal Tax System Is Based upon Separate Accounting, Deferral of Recognition of Income, and Sourcing of Income with Regard to Foreign Subsidiaries

In allocating the income of corporate members of a multinational group, the basic position of the federal system is a recognition of the separate character of each member. Thus the income of a United States member of the group is determined on a separate accounting basis, *i.e.*, by separately determining the income earned and the expenses incurred by the United States corporation. Under this method, if the parent of the affiliated group is a United States corporation, the taxable income of the parent is separately determined without taking into account the income of its foreign subsidiaries. Federal taxation of the income of the foreign subsidiaries is therefore deferred until the subsidiaries pay a dividend to the parent.[15] Double

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[14] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the S. Comm. on Foreign Relations*, 95th Cong., 1st Sess. 28 (1977) (Statement of former Assistant Secretary of Treasury for Tax Policy, Laurence N. Woodworth) [Hereinafter "Woodworth"].

[15] Hufbauer and Foster, "U. S. Taxation of the Undistributed Income of Controlled Foreign Corporations," Tax Policy Research Study No. 3, Essays in International Taxation: 1976, Dept. of the Treasury (1976) p. 1, *et seq.* A limited exception to deferral occurs in I.R.C. §§ 951-964 wherein shareholders are currently taxed on income of a controlled foreign corporation in certain potential "tax abuse" situations, and in I.R.C. §§ 551-558, relating to foreign personal holding companies.

taxation is eliminated by granting to United States domestic corporations credits against income taxes paid to foreign governments. I.R.C. §§ 901-904.

To ensure that the United States collects a fair share of the tax revenues from businesses engaged in foreign commerce, the Internal Revenue Service is given authority to monitor transactions between a United States corporation and its foreign affiliate. I.R.C. § 482. This system recognizes the integrity of separate corporate organizational structures in terms of their primary liability for taxes, but grants the IRS authority to reallocate any income, deduction or other item affecting taxable income among affiliated corporations, if such reallocation is necessary to determine the true taxable income of each based on arm's-length standards. Thus, the United States system is based upon and policed by the principles of separate accounting.

Coincident with the separate accounting rules are the so-called source rules—that is, the rules for determining whether and to what extent certain types of income are to be considered as derived from sources within the United States or from foreign sources. A mechanism exists at the federal level and in the tax treaties for determining the amount of foreign source income. I.R.C. §§ 861, *et seq.*

2. The Income Tax Treaties of the United States Implement Federal Policy

The separate accounting, arm's-length standard not only is the method used by the tax laws of the United States for allocating income among related taxpayers, it is also "the internationally accepted norm" for such allocation.[16] All the income tax treaties in force between the United States and the other countries of the world apply the arm's-length

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[16]Woodworth at 33. *See also, Income Tax Treaties: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 96th Cong., 2nd Sess. 61 (1980) (statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury).

standard.[17] There are 25 such income tax treaties currently in force between the United States and other countries; 10 others are signed but not yet in effect.

Thus the federal government utilizes a series of measures for allocating and taxing income earned by corporate members of a multinational group: (i) taxation of United States members by the separate accounting, arm's-length method; (ii) deferral of taxation of the income of foreign subsidiaries of a United States parent until dividends are paid; (iii) specific sourcing of a number of items of income. These measures are designed to produce an appropriate allocation of income between the United States and foreign countries, and together with the foreign tax credit, are aimed at eliminating double taxation, thereby promoting the policy of the United States to encourage the free flow of capital and technology.

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[17]Woodworth at 33.

The separate accounting, arm's-length standard is embodied in the model convention proposed by the OECD (Organization for Economic Cooperation and Development) of which there are 24 members, including the United States. Article 9(1), OECD Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital (1977), 1 Tax Treaties (CCH) ¶ 151 (hereinafter "OECD Model Convention"). On June 16, 1981, the Treasury Department released its revised draft of the United States Model Income Tax Treaty which also adopts the separate accounting, arm's-length standard. As with most recently concluded United States tax treaties, the new model closely follows the OECD Model Convention. *See*, United States Model Income Tax Treaty (June 16, 1981), Article 9(1), 1 Tax Treaties (CCH) ¶ 158; *see also* the treaties between the United States and other countries cited in Appendix A to the brief *amicus curiae* of the Confederation of British Industry filed in this case, all of which adopt the arm's-length standard. The United Nations' model treaty also provides for use of the separate accounting, arm's-length standard. United Nations Model Taxation Convention Between Developed and Developing Countries, Article 9(1), 1 Tax Treaties (CCH) ¶ 171.

3. The Worldwide Unitary Combined Reporting System, Which Imposes an Entirely Different Method of Apportioning Income upon Multinational Corporate Groups, Is in Irreconcilable Conflict with the Federal System

Under the unitary system, when an enterprise doing business in California is part of a group carrying on a "unitary business" under California's rules, a combined report of the group's worldwide income is required.[18] Where multinational business operations are concerned, California does not limit its requirement of a combined report to enterprises in which the parent corporation is headquartered in California or the United States.[19]

California's method of taxation completely contravenes the three basic tenets of the federal system outlined above.[20] The assumption underlying the combined unitary reporting system is that the income of affiliated corporations which are members of a "unitary group" cannot be determined by separate accounting and that intercompany charges cannot be adequately established. Furthermore, the unitary system immediately includes the income of the foreign subsidiaries of United States parents in the apportionable base and does not recognize the necessity of sourcing various items of income.

These substantial theoretical differences are matched by equally significant differences when the two systems of taxation are put into actual practice. For example, the federal system recognizes the simple fact that a corporate member of an affiliated group operating in one country can be more profitable than another member of the same

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[18]Title 18, California Administrative Code, § 25120.

[19]*Appeal of Beecham, Inc.*, Cal. Tax Rep. (CCH) ¶ 205-635 (Cal. St. Bd. of Equalization, 1977); *Appeal of Shachihata, Inc., U.S.A.*, Cal. Tax Rep. (CCH) ¶ 206-076 (Cal. St. Bd. of Equalization, 1979).

[20]Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 *Harv. J. of Law and Policy in Int'l Bus.* 409, 415-16 (1978).

group operating in another country. Unitary apportionment denies that fact. Under the unitary approach, the profit of the total group is apportioned among its members according to the factors used in the formula. As discussed above, at page 15, if some members are in fact more profitable with regard to the apportionment factors than others, the income of the more profitable members will be apportioned to those with lesser profit, or no profit at all.

Thus, the federal system and the unitary system are in sharp conflict both in theory and in result. Furthermore, since the foreign governments of the world have also adopted the separate accounting, arm's-length standard for apportioning the income of multinational affiliated corporations both in their internal laws and in their tax treaties, California's use of the unitary system obviously conflicts with their system of apportionment and, as discussed at pp. 21-26 above leads to double taxation.

The resulting conflicts between specific allocation and apportionment were discussed by the Court in *Japan Line:*

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an *asymmetry* in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such *retaliation* of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. *If other States followed* the taxing State's example, various instrumentalities of commerce could be subject to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

441 U.S. at 450-51 (footnotes omitted and emphasis added).

The application of these principles to this case is striking. California's novel unitary approach creates an asymmetry in the international tax structure, since the custom of nations has been to determine taxable income based on separate accounting.[21] This point has been emphasized many times recently in diplomatic communications which the United States Treasury and State Departments have received from foreign governments. See Appendices 1a-9a of the United States Memorandum as *amicus curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349. More recent communications from Canada and the ten European Community governments are attached hereto as Appendices D and E at A-6 and A-8. Thus, California, like Los Angeles County in *Japan Line*, has imposed upon the international community a dramatically different method of taxation, thereby creating a climate where "international disputes over reconciling apportionment formulae may arise." 441 U.S. at 450. Furthermore, retaliation could easily take place. For example, a recent debate in the British Parliament discussed the possibility of Great Britain retaliating against the California system by imposing the worldwide unitary method upon United States corporations with subsidiaries in Great Britain.[22]

The Court's sentence beginning with the phrase "if other states followed . . ." quoted above is particularly appropriate since at least 12 other states have already followed California's lead. As a result, the ability of the United States to speak with one voice has been increasingly impaired, inasmuch as the states have not agreed, *inter alia*, upon a uniform tax base, a uniform definition of a unitary business, or uniform apportionment formulas.[23]

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[21]"In this connection I would note that the arm's-length standard is the internationally accepted norm for apportioning income between related taxpayers. It is confusing to other countries and *disconcerting to international relations* when our states use a different standard." Woodworth at 33 (emphasis added).

[22]House of Commons, *Official Report*, 27 April 1982, vol. 22, No. 105, c. 823-8.

[23]G.A.O. Report at 12-21.

It is true that Congress has not established a particular system which states must follow in determining income earned within the state from foreign commerce. Nor has Congress expressly prohibited the states from employing the unitary method for determining the taxable income of a business engaged in foreign commerce. Nevertheless, this Court has invalidated state legislation in conflict with federal policy even in the absence of an express federal statute. The test, as stated in a case passing on a Pennsylvania statute, is as follows:

> Our primary function is to determine whether . . . Pennsylvania's law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.

Hines v. Davidowitz, 312 U.S. 52, 67 (1941). A similar test was applied in *McGoldrick v. Gulf Oil Corp.,* 309 U.S. 414 (1940), where the Court invalidated a New York City sales tax imposed on sales of fuel oil to ocean-going vessels on the ground that the tax was in conflict with federal policy.

This test was also applied in *Japan Line,* which presents the closest analogy to the present case. In that case the Court invalidated a county property tax on the ground that the levy would frustrate federal policy, even though there was no federal statute or treaty explicitly so providing. The applicable treaty involved exempted from federal taxes and customs duties containers owned by foreign based corporations as long as the containers, while in the United States, were used solely in foreign commerce. Although the treaty pertained only to federal taxes (as is true with the income tax treaties in this case), the policy of the United States was clear. The containers were to be exempt from taxes and duties while in the United States, thus leaving taxation of the containers solely to the country of the owner's domicile and eliminating double taxation. The Court held that Los Angeles County's tax was an obvious impairment of the federal policy established to eliminate double taxation in this area.

In regard to Container, to the extent that the unitary method produces an amount of taxable income for Container's United States operations which exceeds the amount determined on an arm's-length basis (which is true for each of the years in issue, see p. 16, *supra*), necessarily California taxes foreign source income as that term has been defined for federal income tax purposes. Since no California tax credit or deduction is available for foreign taxes paid on this income, double taxation of such income is inescapable. Such improper apportionment of income and resulting double taxation unavoidably frustrate the United States foreign policy of promoting the free international flow of capital and technology and therefore violates the commerce clause.

E. The Analysis Contained in the Solicitor General's Amicus Memorandum in Chicago Bridge & Iron Requires Reversal of the Judgment Below

Last Term in *Chicago Bridge & Iron* the Solicitor General filed an *amicus* memorandum at the behest of the Departments of State and Treasury, the Department of Commerce (acting at the request of the Delegation of the Commission of the European Communities) and the United States Trade Representative. In that memorandum, the Solicitor General urged that the imposition of a comparable Illinois income tax on the apportioned combined worldwide business income of a unitary group of related corporations violated the Commerce Clause. Since the Court has restored that case to the calendar for reargument without setting it in tandem with the argument in the instant case, we have reproduced the salient portions of the United States memorandum for the convenience of the Court in the Appendix, at A-10. Indeed, given the Solicitor General's explicit suggestions, later reinforced by our own motion, that the Court note probable jurisdiction here in order to consider the question "in the context of a case involving multiple taxation in fact," Appendix F at A-20, Appellant believes that his memorandum is highly pertinent to the disposition of this case as well.

The analysis contained in the Solicitor General's *amicus* memorandum in *Chicago Bridge & Iron*, in the context of the facts of this case, requires reversal of the judgment below. The Solicitor General relied upon *Japan Line* as the "seminal decision" (*Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 Transcript of Oral Argument, April 19, 1982, at 16 ["Tr."]) that "undermines the basis of the decision below and invalidates the unitary apportionment method as applied to multinational corporate groups," Appendix F at A-14 (foonote omitted). As the memorandum stated, *id.* at A-17:

> We submit that analysis of the Illinois tax under the principles of *Japan Line* requires the conclusion that the combined apportionment method, applied to a unitary business with foreign corporate constituents, is barred by the Commerce Clause. Like the ad valorem tax at issue in *Japan Line*, the Illinois tax violates both precepts discussed in that decision insofar as it creates a substantial risk of international multiple taxation and impairs federal uniformity in the conduct of foreign relations.

Thus, the Solicitor General identified the two grounds upon which the Court rested its decision in *Japan Line*: "first, as the Court said, the enhanced risk of multiple taxation, and second, the need for federal uniformity in the conduct of international relations and foreign trade." Tr. 16.

Here, as Container has pointed out (*supra*, at 21-26), the application of the California tax in this case does not simply create a risk of multiple taxation but "creates multiple taxation in fact." *Japan Line*, 441 U.S. at 452, n.17. In these circumstances, as the Solicitor General observed, Appendix F at A-19:

> both the state and the foreign country would tax such apportioned income, thereby resulting in international double taxation of the same income. In this manner, the state unitary method frustrates the federal policy,

consistent with international usage, of avoiding or mitigating international double taxation.

Moreover, the Solicitor General also emphasized the fact that a state tax such as California's "is still invalid because it impairs federal uniformity" insofar as "it prevents the federal government from 'speaking with one voice' in international trade." Appendix F at A-20. In this respect, he noted, in terms that apply equally to the California levy at issue here, that:

> [T]he United States and most foreign countries use the arms-length method of allocating income between corporations. Illinois' variant unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income. *Id.*

Finally, the Solicitor General concluded, *Id.* at A-21:

> In sum, "the freedom of the States to formulate independent policy in [the] area [of commerce] may have to yield to an overriding national interest in uniformity" *Moorman Manufacturing Co. v. Bair, supra,* 437 U.S. at 280. . . . The income taxation of multinational businesses is thus a matter that is subject only to a national rule conformable with the practice of nations or adopted pursuant to the President's authority "by and with the Advice and Consent of the Senate to make Treaties * * *" or Congress' power "[t]o regulate Commerce with Foreign Nations * * *." "[Illinois], by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Japan Line, Ltd. v. County of Los Angeles, supra,* 441 U.S. at 453.

If, as appellant submits and the Solicitor General has argued in his *amicus* memorandum, the Court concludes that the California combined reporting method either: (a) imposes international double taxation in fact, *or*

(b) impairs federal uniformity in the conduct of foreign relations, that is the end of the matter, and the judgment below should be reversed. In these circumstances, the California combined reporting method cannot be constitutionally applied to any multinational group of corporations—a result that appellant and the Solicitor General believe to be compelled by the commerce clause. See Appendix F at A-22.

To be sure, the United States "views the [case of the] foreign parent [corporation] with particular and special concern." Tr. 23. As the Solicitor General correctly pointed out, there are "other burdens that the state unitary method will impose on international trade and foreign relations," in the case of the foreign parent corporation. Appendix F at A-22. But under the analysis that proceeds from *Japan Line*, to which appellant and the Solicitor General both subscribe, there is no meaningful constitutional distinction between the case of a United States parent and its foreign subsidiaries and the case of a foreign parent with United States subsidiaries. In either situation, the combined reporting method is constitutionally prohibited if, as here, it results in international double taxation. What is more, the combined reporting method necessarily impairs federal uniformity, and is constitutionally prohibited, because it aggregates the income of commonly controlled entities in a manner that is sharply at variance with the internationally accepted arm's-length method of allocating income among related corporations.

II

BECAUSE THERE IS NO SUBSTANTIAL OPERATIONAL INTERDEPENDENCE BETWEEN CONTAINER AND ITS FOREIGN SUBSIDIARIES, THE DUE PROCESS CLAUSE PROHIBITS THE TAXATION OF CONTAINER AND THE FOREIGN SUBSIDIARIES AS A SINGLE UNITARY BUSINESS, REGARDLESS OF WHETHER OR NOT WORLDWIDE FORMULA APPORTIONMENT IN GENERAL IS PERMISSIBLE

It is a fundamental constitutional principle that the due process clause prohibits a state from taxing value earned outside its borders. The taxing power exerted by a state must bear a substantial relation to the protection, opportunities, and benefits provided by a state. Thus, the "simple but controlling question is whether the state has given anything for which it can ask return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).

In the present case, California asserts a right to include in the apportionment formula income earned by subsidiaries of Container operating entirely in foreign countries. However, California cannot include the subsidiaries' income in the apportionment formula unless Container and its foreign subsidiaries possessed such substantial operational interdependence that they constitute a single unitary business under the criteria enunciated by this Court. As this Court has recently reiterated, "[t]he 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principle'." *ASARCO Inc. v. Idaho State Tax Commission*, ... U.S. ....; 50 U.S.L.W. 4962 (1982) (Slip Op. at 11, *quoting Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 223 (1980), in turn quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980)). The facts of the present case compel the conclusion that, especially under the criteria set forth in the Court's recent decisions in *ASARCO*

and *F. W. Woolworth Co. v. Taxation & Revenue Dept.*, ... U.S. ....; 50 U.S.L.W. 4957 (1982), Container and its foreign subsidiaries do not operate as a single unitary business and California's combination of them is prohibited by the due process clause.

This Court has recently decided several cases in which various states have asserted that a unitary business existed. In two of the cases, "the states prevailed because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products." *ASARCO,* Slip. Op. at 22, n.24. In *ASARCO* and *Woolworth,* however, because "these essential factors [were] wholly absent," the Court found that the businesses involved were not unitary. *Id.; Woolworth* Slip. Op. at 16-17. Here too there is no continuous flow and interchange of common products between Container and its foreign subsidiaries, and because "the parent company's operations are not interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization' of capacity," Container and its foreign subsidiaries cannot be taxed as a single unitary business. *Woolworth,* Slip Op. at 15 quoting *Exxon,* 447 U.S. at 218.

Exxon, Woolworth, and *ASARCO* establish beyond peradventure that two or more corporations cannot be combined into a single unitary business unless there is a substantial operational interdependence between the operations of the corporations. Thus in *Exxon,* a vertically integrated company with a continuous flow of products within the United States, constituted a single unitary business because it was a "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." *Exxon,* 447 U.S. at 224. Where there was no such functional integration, however, and none of the substantial operational interdependence which was evident

in *Exxon*, the Court found that a unitary business did not exist. *See ASARCO; Woolworth.*

The relationship between Container and its foreign subsidiaries is virtually identical to the relationship between Woolworth and its foreign subsidiaries. In both cases, the foreign subsidiaries engaged in the same general line of business as the parent. The operations of the subsidiaries were highly decentralized, so that the subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations. Stip. ¶ 61, J.A. 30; *Woolworth*, Slip Op. at 9-10. Thus, in both cases, "*no phase* of any subsidiary's business was integrated with the parent's." *Woolworth*, Slip Op. at 10 (emphasis added).

Here there was an insignificant transfer of goods or products between Container and its foreign subsidiaries. In *Woolworth* there was apparently no transfer at all. Stip. ¶¶ 26, 141, 143, J.A. 15-16, 73, 74; *Woolworth*, Slip Op. at 15. In both cases, the management of the foreign subsidiaries had complete control over business decisions affecting their operations. Stip. ¶ 74, J.A. 39-40; *Woolworth*, Slip Op. at 12. Container's foreign operation staff consisted of only five people, three of whom devoted only part of their time to foreign operations, while Woolworth had one vice president who evidently devoted all of his time to acting as "liaison man" with the smaller foreign subsidiaries and occasionally contacting the major subsidiaries. *Id.* at 13, n. 16. The personnel departments of both Container's and Woolworth's foreign subsidiaries were fully independent operations, dedicated to recruiting and training nationals to fill positions at every level of the business. Stip. ¶¶ 79, 89, 95, 109, J.A. 42-3, 48, 51, 56; *Woolworth*, Slip Op. at 12.

In addition, there are a number of other items which the Court identified in *Woolworth* and *ASARCO* to which

the facts in the instant case are similar.[24] The overriding fact, however, as emphasized by the Court in both *Woolworth* and *ASARCO*, is that, as in the present case, "[e]xcept for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of [the corporations involved]." *Woolworth*, Slip Op. at 15.

Furthermore, the approach of the Court of Appeal in *Container* to the unitary issue was much like that of the lower courts in *ASARCO* and *Woolworth*. Thus, the Court of Appeal "in important part analyzed this case under a different legal standard" than the one adopted by this Court. *Woolworth*, Slip Op. at 8. As did its counterparts in the other two cases, the Court of Appeal in the present case relied heavily on Container's *potential* ability to operate the foreign subsidiaries as part of the unitary business. For example, the Court of Appeal noted that Container bought no raw materials or finished products from its subsidiaries and sold only small quantities of paperboard and raw materials (and no finished products) to its subsidiaries. Nevertheless, the opinion gave weight to the fact that the subsidiaries *could* have bought more materials from the

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[24] There are, of course, some small differences between the *Woolworth* and *Container* cases. In some instances, the facts indicate that Container and its subsidiaries have fewer links between them. For example, in *Woolworth*, the parent and the foreign subsidiaries all used the same general "F.W. Woolworth" corporate name. Slip Op. at 14, n.22, while Container's foreign subsidiaries did not use the "Container Corporation of America" name. Stip. ¶ 25, J.A. 14-5. In other instances, the facts indicate that some links in the *Woolworth* case were even more tenuous than in the present case. For example, the foreign subsidiaries of Container did owe some money to the parent at the end of each of the years in question and a very small number of Container employees had transferred to the foreign subsidiaries.

parent.[25] J.S. at A-8, A-9. Additionally, while the Court of Appeal did not dispute the fact that the foreign subsidiaries controlled their own operations and set their own policies, the Court emphasized that important decisions were "subject to" review by Container's management and seemed to give this potential review the same significance as if Container had made the decisions itself. J.S. at A-3.

This Court has made clear that the *potential* ability to operate a company as part of a unitary business is not dispositive, but that the companies must be operated as an integrated enterprise in fact. *Woolworth*, Slip Op. at 7-8; *ASARCO*, Slip Op. at 15-16. The Court noted that in *Woolworth* "[d]ecisions about major financial decisions, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, had to be approved by the parent." *Woolworth*, Slip Op. at 14. However, this review, and the potential for control which it may entail, did not warrant combination as a unitary business.

The "different legal standard" used by the Court of Appeal in this case extended considerably beyond its use of *potential* unitary ties as its yardstick. In reaching its

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[25] In some instances, the Court of Appeal went beyond even *potential* unitary features, reasoning that a decision not to integrate operations was an indication that a unitary business existed. The Court of Appeal, in listing what it believed were features indicating operational unity, thus refers to the fact that the foreign subsidiaries "followed" Container's "policy of regional decentralization." J.S. at A-12; *see also* J.S. at A-2. Even if there was any evidence that the parent imposed such a standard on the subsidiaries (which there was not), the Court of Appeals position would lead to the absurd conclusion that if the parent "imposed" anarchy on the foreign subsidiaries as a management philosophy, such anarchy would be an indication that a unitary business existed. This confusion of the "potential" unitary feature of control with true functional integration has been rejected in *ASARCO* and *Woolworth*, since "[t]he state court's reasoning would trivialize [the] due process limitation." *Woolworth*, Slip Op. at 8.

conclusion, the Court of Appeal also failed to require the existence of meaningful, operational relationships between Container and the f reign subsidiaries and relied instead, at least in part, upon an administrative presumption that corporations engaged in the same line of business are unitary.[26] *Woolworth* and *ASARCO* clearly indicate that, just as the potential for a unitary business is not a justification for combination, an administrative presumption cannot be used as a basis for combining corporations into a single unitary group.[27]

In sum, both *Woolworth* and the instant case fall on the same side of the "critical distinction" set out by the Court in *Woolworth:*

> There is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—

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[26]In this connection the court stated as follows:

> Appellant engaged in the same business activities as its subsidiaries. The administrative regulations indictate that a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business. This administrative construction of the California tax laws "is entitled to great weight, and the courts generally will not depart from construction unless it is clearly erroneous or unauthorized."

J.S., A-15-A-16 (footnote and citations deleted). The relevant administrative regulation, Title 18, California Administrative Code, § 25120(b) is set forth in full at J.S., A-39-A-40. The relevant portion is quoted in footnote 4 to the lower court's opinion. J.S. A-15-A-16.

[27]Furthermore, other decisions of the Court indicate that, as in the present case, an opposite presumption is required. As demonstrated at pages 11-18, combination of Container and its foreign subsidiaries into a single unitary group results in a substantial misattribution of income to California. As a result of this strong evidence of distortion, at a minimum the state is required to counter the evidence. Absent such rebuttal, a presumption arises against the state's apportionment. This was precisely the approach taken by the Court in *Norfolk & Western Ry. Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968).

> in which refined, processed, or manufactured products (or parts thereof) may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense which our cases consistently have used these terms.

Woolworth, Slip Op. at 16-17 (footnote omitted). As noted above, Container's subsidiaries in each foreign country produced and marketed their own products in each country. As in *Woolworth*, "there is no flow of international business," *i.e.* no flow of goods, and no "substantial mutual interdependence." *Id.*

The Court's opinion in *Woolworth*, as well as its decisions in *Exxon* and *ASARCO*, indicate that, in the case of a manufacturing or mercantile business, there can be no unitary business without a "flow of trade" between the affiliated corporations. Prior state income tax cases before the Court involving the unitary issue in the context of a manufacturing or mercantile business have been cases in which there has been a substantial flow of goods or products between affiliated corporations.[28] In *ASARCO*, while the Court held that a substantial product flow alone did not mean that affiliated corporations were unitary (*see* the discussion of Southern Peru Copper Corp. at pp. 13-15

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[28] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) (integrated manufacture and sale of animal feeds); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942) (integrated wholesale business involving centralized purchasing of inventory); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924) (integrated manufacture and sale of ale); and *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters).

of the *ASARCO* slip opinion), the Court indicated that a substantial transfer of product was essential to the unitary combination of manufacturing or mercantile enterprises. The Court stated that it had previously approved unitary combination of such businesses "because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products." *ASARCO*, Slip Op. at 22, n. 24.

In the court below, Container urged that a "bright line" standard be adopted as a *sine qua non* for finding a business to be unitary, namely that, as to manufacturing or mercantile enterprises, there must be a substantial flow of goods. While this Court has adopted such a standard by implication in its recent cases, it is respectfully submitted that express adoption of the standard in this case would add much needed certainty to this area for lower courts, tax administrators and taxpayers alike. Such a standard has been adopted by courts in at least two states and has been advocated by the leading commentator in the area. *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Ash Grove Cement Co.*, Or.T.R. (CCH) ¶ 203-221 (Or.Tax.Ct. 1977); Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business", 21 *Nat'l Tax J.* 487, 501-02 (1968).

Explicit adoption of a substantial flow of goods requirement would reflect the reason for the development of formulary apportionment. The use of apportionment originated in cases where there was such complete operational interdependence, evidenced by a flow of products or raw materials, that "[t]he legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Bass Ratcliff & Gretton Ltd. v. State Tax Commissioner*, 266 U.S. 271, 281 (1924). Hence, for enterprises such as those that manufactured goods in one state or

country and sold them in others, apportionment became a useful tool. However, in the absence of such basic operational interdependence, there is no need, and no justification, for apportionment. The reasons for this conclusion have been thoughtfully described as follows:

> [C]entralized operations may be a factor in the greater profitability of some larger enterprises, as compared with smaller businesses. But that is not the linchpin of formulary apportionment. The costs of these centralized operations can be spread by cost accounting methods regularly used by accountants for internal accounting, SEC registration statements, reports to regulatory agencies for rate making, and for other purposes. . . . The underlying point is . . . that such matters require a spreading of costs, which can be acceptably accomplished by distributing charges on a time, or gross volume basis, or by other workable methods, and do not involve the elusive effort to segregate profits between interdependent steps in operations, such as producing in one state and selling in another.
>
> Consequently, the non-operating functions of an enterprise, . . . although centralized, ought not lay the basis for holding the enterprise unitary. Not only is there no reason in the considerations which gave birth to formulary apportionment to push the technique to this point, but perhaps of greater moment is the fact that so broad a sweep of formulary apportionment tends to push distortion and misallocation to unacceptable levels.

Hellerstein, *supra* at 501-02.

The substantial flow of goods requirement has the further advantage of introducing an objective factor into an otherwise largely subjective determination as to whether the business is unitary. Adopting such an objective standard would reduce the number of cases in which it is necessary

to refer to more abstract factors such as centralized management and operations and the like. For example, under a substantial flow of goods requirement, Container and its subsidiaries could not be members of a single unitary business.

In any event, *ASARCO* and *Woolworth* require a holding that Container and its foreign subsidiaries are not members of a unitary business. Without the existence of a single unitary business, California's method of taxation violates the due process clause of the United States Constitution. Thus, California cannot apply its method of taxation to Container and its subsidiaries.

CONCLUSION

For the foregoing reasons, Container submits that California's system of worldwide combination on a unitary basis should be invalidated and the decision of the California Court of Appeal reversed.

Dated: July 30, 1982.

Respectfully submitted,

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PRENTISS WILLSON, JR.
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Container Corporation of America

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(Appendices follow)

Appendix A

Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries[1]

Country	Sex	Year 1963	1964	1965
United States	MF	2.46	2.53	2.61
Australia	M	2.05	2.11	2.21
	F	1.43	1.49	1.54
Austria	MF	.55	.60	.65
Belgium	M	.74	.83	.90
	F	.45	.51	.56
Canada	MF	1.80	1.88	1.97
Ceylon	MF	.15	.15	.16
Chile	MF	.24	.30	.32
Colombia	MF	.30	.30	.23
Denmark	MF	1.17	1.27	1.43
El Salvador	MF	.28	.28	.29
Finland	MF	.81	.92	1.00
France	MF	.54	.58	.61
Germany	MF	.87	.94	1.03
Ghana	MF	.70	.76	.35
Greece	MF	.28	.31	.34
Guatemala	MF	.36	.36	.37
Ireland	MF	1.40	1.55	1.65
Israel	MF	.58	.64	.73
Italy	MF	.54	.59	.62
Japan	MF	.43	.48	.52
Korea	MF	.14	.09	.10
Mexico	MF	.48	.53	.56
New Zealand	MF	2.33	2.44	2.59
Norway	M	1.11	1.18	1.28
	F	.77	.83	.92
Peru	MF	.32	.35	.35
Philippines	MF	.23	.23	.22
Puerto Rico	MF	1.13	1.18	1.24
Sweden	MF	1.41	1.54	1.69
Switzerland	M	.98	1.06	1.14
United Kingdom	M	2.48	2.67	2.93

[1]Source: United Nations, *Monthly Bulletin of Statistics*, January 1968, Table 57 at 132, based on data from the International Labor Office.

M refers to wages of males, F refers to wages of females, and MF to a single composite figure. Figures normally include bonuses, cost of living allowances, taxes, social insurance contributions pay-

able by the employed person and, in some cases, payments in kind. They normally exclude social insurance contributions payable by the employers, family allowances and other social security benefits. In a few instances, family allowances and salaried employees have been included in the figures. The information published by the United Nations is stated in terms of the local currency, which we have translated into dollars by the applicable midpoint exchange rates (in most cases) published in the United Nations, *Monthly Bulletin of Statistics*, January 1969, Table 64 at 192. In those cases in which daily, weekly, or monthly wage rates are given in the U.N. figures, we have assumed an 8-hour day, 44-hour week or 190.5-hour month for conversion purposes, which we regard as highly conservative. The foregoing table omits some of the countries as to which information is provided, most of which are in the Soviet bloc. In all cases with respect to the countries omitted, the average hourly earnings are substantially below those of the United States.

Appendix B

Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries[1]

Country	1974	1975	1976	1977	1978	1979	1980
United States	$4.42	$4.83	$5.22	$5.68	$6.69	$ 6.69	$7.27
Australia	2.98M	3.37M	3.34M	3.90M	4.21M	4.37M	5.16M
	2.51F	3.09F	3.13F	3.68F	3.96F	4.06F	4.78F
Austria	2.36	2.48	2.99	3.59	4.30	4.89	4.75
Barbados	.85M	1.00M	1.12M	1.32M	—	—	—
Belgium	3.47	3.65	4.44	5.30	6.40	7.12	—
Canada	4.41	4.98	5.71	5.83	5.77	6.37	6.85
Chile	.13	.13	.24	.42	.60	.77	1.18
Colombia	.37	.40	.45	.54	.65	.81	.93
Denmark	5.34	5.82	6.93	7.61	9.53	10.06	9.99
Ecuador	.43	.53	.65	.73	.79	—	—
El Salvador	.45M	.46M	.58M	.62M	.68M	.76M	—
Finland	2.69	3.01	3.56	3.63	4.00	4.71	5.14
France	1.89	2.19	2.24	2.63	3.40	3.99	4.09
Germany, F.R.	3.71	3.70	4.38	5.29	6.42	7.14	6.73
Greece	.93	.97	1.21	1.52	1.85	2.10	2.20
Guatemala	.44	.46	.49	.53	.60	—	—
Ireland	1.95	2.22	2.15	2.81	3.63	4.30	4.40
Italy	1.86	2.62	2.44	3.07	3.91	4.82	—
Japan	2.55	2.82	3.29	4.39	5.79	4.99	6.33
Korea	.33	.42	.56	.75	1.01	1.30	1.17
Malawi	.24	.23	.23	.26	.30	.33	—
Mexico	1.18	1.43	1.13	1.30	1.49	1.74	2.05
New Zealand	2.92	2.65	2.76	3.41	4.08	4.36	—
Norway	4.19M	4.68M	5.87M	6.57M	7.26M	7.60M	7.91M
	3.22F	3.65F	4.66F	5.25F	5.82F	6.12F	6.48F
Philippines	.24	.23	—	—	—	—	—
Spain	1.40	1.75	1.99	—	—	—	—
Sweden	4.98	5.43	5.84	5.50	6.51	7.26	7.47
Switzerland	4.03M	4.24M	4.62M	5.78M	7.36M	7.78M	7.40M
United Kingdom	2.62M	2.83M	2.65M	3.22M	3.97M	5.06M	6.35M
Venezuela	1.58	1.80	1.85	2.02	2.29	—	—

[1]Source: United Nations, *Monthly Bulletin of Statistics*, September 1981, Table 57.

M refers to wages of males, and F wages of females; in other countries single composite figures are given. Figures normally include bonuses, cost of living allowances, taxes, social insurance contributions payable by the employed person and, in some cases, payments in kind. They normally exclude social insurance contributions payable by the employers, family allowances and other social security benefits. In a few instances, family allowances and salaried employees have been included in the figures. The information published by the United Nations is stated in terms of the local currency, which we have translated into dollars by the applicable midpoint exchange rates (in most cases) published in the

United Nations, *Monthly Bulletin of Statistics*, September 1981, Table 62. In those cases in which daily, weekly, or monthly wage rates are given in the U.N. figures, we have assumed an 8-hour day, 44-hour week or 190.5-hour month for conversion purposes, which we regard as highly conservative. The foregoing table omits some of the countries as to which information is provided, most of which are in the Soviet bloc. In all cases with respect to the countries omitted, the average hourly earnings are substantially below those of the United States.

Appendix C

Percentage of U.S. Average Hourly Compensation, Adjusted for Estimated Differences in Productivity[1]

Country	1969	1970
Japan	40	40
West Germany	61	72
United Kingdom	65	68
Belgium	60	61
Canada	79	82
France	58	54
Italy	62	67
Netherlands	74	71
Sweden	72	74

The data presented by the study represents, for 1969 and 1970, respectively, the estimated percentage of U.S. hourly compensation required as the average in each country to produce a quantity of manufactured goods equivalent to that produced in the United States.

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[1]Source: United States Tariff Commission, *Competitiveness of U.S. Industries* (T.C. Publication 473) at 30 (1972).

Appendix D

No. 283

The Embassy of Canada presents its compliments to the Department of State and has the honour to refer to its Notes No. 692 and 245 of 22 December, 1981 and 10 May, 1982, together with the exchange of letters between the Secretary of the Treasury for the United States of America and the Canadian Minister of Finance of 26 September, 1980 on the occasion of the signing of the bilateral convention with respect to taxes on income and capital.

The Embassy has been instructed to draw again the attention of United States authorities to Canada's concerns about the unitary tax apportionment method used by certain states in the United States to allocate income to United States offices or subsidiaries of international corporations based on the corporation's worldwide earnings. The Canadian Government continues to be of the view that this method results in inequitable taxation and imposes excessive administrative burdens on international companies doing business in those states. Under this method the profit of a Canadian company, for example, on its United States business is not determined on the basis of arm's-length relations, but is derived from a formula taking account of the income of the Canadian company and its worldwide subsidiaries, as well as the assets, payroll and sales of each of these.

For a multinational company with subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden.

Against this background the Canadian Government welcomed the decision of the Justice Department to file an amicus curae brief before the Supreme Court concerning the appeal of the Chicago Bridge and Iron Company

against the use of the unitary tax method applied by the State of Illinois. The Embassy has now noted that another such case will be considered by the Supreme Court later this year involving an appeal by Container Corporation of America versus the Franchise Tax Board (California) (Case 81-523). The Embassy would wish the foregoing concerns of the Canadian Government to be drawn to the attention of the relevant United States authorities and would welcome these views being referred to in any representation that the United States Administration may be making to the Supreme Court.

The Embassy of Canada avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, June 14, 1982

Appendix E

AMBASSADE DE BELGIQUE

The Embassy of Belgium presents its compliments to the Department of State and, on behalf of the Ten E.C. Governments, of which the Government of Belgium has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Embassy of Belgium welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C. June 29, 1982
[Seal]

Attached: Note

The Department of State
Washington, D.C.

UNITARY TAXATION

1. Our Governments refer to their Note on unitary taxation forwarded on their behalf to the Department of State on 30 October 1981 by Her Britannic Majesty's Embassy.

2. Our Governments remain firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory.

3. As was pointed out in that Note, unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

4. Our Governments wish to draw the attention of the State Department to the case of Container Corporation of America vs Franchise Tax Board which we understand is to be heard in the Supreme Court of the United States during the October Term 1982, and urge as a matter of high priority that the Government of the United States should participate in this case as amicus curiae.

Appendix F

In the Supreme Court of the United States

October Term, 1981

No. 81-349

Chicago Bridge & Iron Company, Appellant

v.

Caterpillar Tractor Co., et al.

On Appeal From the Supreme Court of Illinois

Memorandum for the United States As Amicus Curiae

INTEREST OF THE UNITED STATES

The federal government is charged with the conduct of the Nation's foreign relations. To that end, the Constitution confers upon Congress the power "To regulate Commerce with foreign Nations * * *" (Article I, Section 8, clause 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties * * *" (Article II, Section 2, Clause 2). The watchword in the area of foreign commerce is federal uniformity. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees* v. *United States,* 289 U.S. 48, 59 (1933).

The United States submits that the imposition of the Illinois income tax on the apportioned combined worldwide business income of a unitary group of related cor-

porations, including foreign corporations, impairs federal uniformity in an area where such uniformity is essential. The United States, like most countries, employs the arms-length method of allocating income among commonly controlled corporations, and this method is mandated in numerous treaties, to which the United States is a party, that are intended to prevent international double taxation. Under the arms-length method, the income of each corporation is computed on a separate accounting basis under the assumption that each member of the group must deal with other members as if they were wholly separate entities owned by unrelated interests. Cf. 26 U.S.C. 482, and Treasury Regulations promulgated thereunder. The arms-length method insures against artificial shifting of income and deductions among related businesses. The Illinois apportioned combined method of computing income that is at issue in this case, however, can result in the allocation of taxable income to a corporation that incurs a loss on a separate accounting basis computed in accordance with the arms-length method. Thus, a domestic corporation that operates at a loss and has no federal taxable income may be subject to state taxation on foreign source income earned by its foreign affiliates (*e.g.*, income of a foreign parent or income of a foreign subsidiary that the domestic parent has not repatriated). These sharp differences between federal and international tax policies, on the one hand, and state tax policies on the other, undermine the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976).

Moreover, international double taxation can result if foreign source income subject to the state combined unitary method is also subject to tax in the foreign country in which it is earned. The federal tax laws provide a foreign tax credit in order to mitigate such international

double taxation. See 26 U.S.C. (& Supp. III) 901 *et seq.* States employing the worldwide unitary method, however, do not allow a credit for foreign taxes.

We are accordingly advised by the Departments of State and Treasury, the Department of Commerce, acting at the request of the Delegation of the Commission of the European Communities, and the United States Trade Representative, that a number of foreign governments have complained—both officially and unofficially—that the apportioned combined method empowered by Illinois and other states creates an irritant in their commercial relations with the United States. Retaliatory taxation may ensue, with consequent damage to international trade. Moreover, the method causes uncertainties because it differs from the federal arm's-length standard that is generally accepted in international practice and in bilateral income tax conventions. Since this case poses much the same constitutional problems as existed in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), in which we participated as amicus curiae pursuant to the Court's invitation, we believe that the same federal interest likewise mandates participation here.

DISCUSSION

The question presented in this state income tax case is whether Illinois' imposition of its income tax on the apportioned combined worldwide business income of a group of related corporations, including foreign corporations, violates the Commerce Clause.

* * * *

2. It is settled beyond question that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state as-

pects of interstate affairs." *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 460 (1959); *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 436-442 (1980). See also *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123 (1931); *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942); *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267 (1978).

As the Court stated in *Mobil Oil Corp.* v. *Commissioner of Taxes, supra*, 445 U.S. at 439, "the linchpin of apportionability in the field of state income taxation is the unitiary-business principle" (footnote omitted). In accordance with this principle, the Court has upheld state apportionment formulas, like that of Illinois, which combine the income of several related corporations engaged in a "unitary" business. Income is allocated to the taxing state by multiplying the total net income of the enterprise by a percentage comprised of the average of the ratios of in-state property, payroll, and sales to total property, payroll and sales. See Section 304(a) of the Illinois Income Tax Act, (Ill. Rev. Stat. ch. 120) J.S. App. E16-E18; see also *United States Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452, 475 n.25 (1978); *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207, 214 n.3 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes, supra*, 445 U.S. at 429-430 nn. 2-4. A unitary business is one in which all of the corporate constituents are involved in an economically functionally-related enterprise. As one leading commentator has observed, the "very essence of formulary apportionment [is] that where there are integrated, interdependent steps in the economic process carried on by a business enterprise, there is no logical or viable method for accurately separating out the profit attributable to one step in the economic process from other steps." J. Heller-

stein, *State and Local Taxation* 400 (3d ed. 1969). See also J.S. App. C11; *Butler Brothers* v. *McColgan, supra,* 315 U.S. at 508. *Hans Rees' Sons* v. *North Carolina, supra,* 283 U.S. at 133.

Here, it is not disputed that Caterpillar and its 25 subsidiaries constitute a unitary business enterprise, and the Illinois Supreme Court so concluded (J.S. App. C11-C12). Thus, if Caterpillar and its subsidiaries conducted their business solely within the United States, the foregoing precedents we have cited would establish that the Illinois combined apportionment method would pass muster under the Commerce Clause for purposes of allocating its income among the several states. But Caterpillar is not a domestic enterprise. On the contrary, it conducts a worldwide enterprise and "Commerce Clause scrutiny may well be more rigorous when a restraint on foreign commerce is alleged." *Reeves, Inc.* v. *Stake,* 447 U.S. 429, 438 n.9 (1980).

We submit that the Court's analysis in *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 434, undermines the basis of the decision below and invalidates the unitary apportionment method as applied to multinational corporate groups.[4] In *Japan Line,* the Court struck down a

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[4]*Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271 (1924) has no bearing on the question presented here. That case involved the application of a New York apportionment formula to a single British corporation which manufactured its product in England and sold it in New York through branch offices. See *id.* at 282. The taxpayer did not conduct its business in multinational corporate group form. There was accordingly no occasion for the Court to consider the constitutionality of the combined apportionment method and its inconsistency with the arms-length method in a multinational corporate setting. Compare *Hans Rees' Sons v. North Carolina, supra,* 283 U.S. at 132-133, with *Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. at 438-439, 440-441.

California ad valorem property tax, as applied to a Japanese company's shipping containers, as unconstitutional under the Commerce Clause because it resulted in multiple taxation of the instrumentalities of foreign commerce, and prevented this Nation from "speaking with one voice" in regulating foreign trade and thus was inconsistent with Congress' power to "regulate Commerce with foreign Nations" (Article I, Section 8, Clause 3). In so holding, the Court pointed out that in the domestic context, "[t]he corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full * * *. The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies" (441 U.S. at 447).

But the Court's ability to avoid multiple taxation by ensuring full apportionment in the domestic context has no counterpart in the international sphere. As the Court explained (441 U.S. at 447-448; footnote omitted)—

> [N]either this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. * * * Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce "' to the risk of a double tax burden to which

> [domestic] commerce is not exposed, and which the commerce clause forbids.'" *Evco* v. *Jones*, 409 U.S. [91], at 94 [1972], quoting *J. D. Adams Mfg. Co.*, 304 U.S., at 311.

Apart from the risk of multiple international taxation, *Japan Line* rests upon a second ground—the need for federal uniformity in an area in which federal uniformity is essential. As the Court stated, "Foreign commerce is preeminently a matter of national concern" (441 U.S. at 448). Since "the Federal Government must speak with one voice when regulating commercial relations with foreign governments" (*Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976)), "[t]he need for federal uniformity is no less paramount in ascertaining the negative implications of Congress' power to 'regulate Commerce with foreign Nations' under the Commerce Clause" (footnote omitted) (441 U.S. at 449). As the Court further pointed out (*id.* at 450-451) (footnotes omitted):

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdiction. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

In determining whether a state tax in the international context is constitutionally valid, it is necessary to examine "whether * * * [it] creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'" (441 U.S. at 451). For "[i]f a state tax contravene *either* of these precepts, it is unconstitutional under the Commerce Clause" (*ibid.;* emphasis supplied).

We submit that analysis of the Illinois tax under the principles of *Japan Line* requires the conclusion that the combined apportionment method, applied to a unitary business with foreign corporate constituents, is barred by the Commerce Clause. Like the ad valorem tax at issue in *Japan Line,* the Illinois tax violates both precepts discussed in that decision insofar as it creates a substantial risk of international multiple taxation and impairs federal uniformity in the conduct of foreign relations.[5] We turn now to an examination of the operation of the Illinois tax in the multinational corporate context.

a. *Risk of multiple international taxation.* As we have pointed out (*supra,* pages 8-9), the Illinois apportionment formula allocates income on the basis of payroll, property and sales. Thus, in order to determine what portion of the worldwide income of a unitary group of corporations is allocable to Illinois, the total worldwide income of all the corporations of the group is multipled by a fraction which

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[5]Hence, there is no basis for the Illinois Supreme Court's conclusion (J.S. App. C18) that *Japan Line* is "obviously distinguishable" because "[t]his appeal does not involve the multiple taxation of items or instrumentalities of foreign commerce nor does unitary reporting affect Federal authority in governing foreign commerce." The same considerations of international multiple taxation and federal uniformity in the conduct of foreign relations upon which *Japan Line* rests are equally applicable to a state income tax.

is the arithmetic average of the three ratios of in-state payroll, property, and sales to total payroll, property, and sales. See *Mobil Oil Corp.* v. *Commissioner of Taxes, supra,* 445 U.S. at 429-430 n.4, 437 n.13.

The theory underlying the three-factor formula, and indeed, the basis for its acceptability for Commerce Clause purposes, is that a dollar of payroll or property spent or a dollar of sales made in one state, produces roughly the same amount of taxable income as a dollar so spent or sales made in another state. See J. Hellerstein, *supra,* at 539. While this assumption may be sound within certain constitutional tolerances in a homogeneous economy such as the United States and thereby provides a basis for the division of interstate income, there is no comparable assumption that can be made in allocating the income of a multinational group. As the amici Container Corporation (Br. 14-18) and the Union of Industries of the European Community point out (Br. 10-11), there are great differences between the cost of property and payroll in the several states, on the one hand, and abroad, on the other, especially in developing nations. These differences would shift a disproportionate share of the foreign source income of a multinational group to state taxation if the three-factor formula were used.

Moreover, state use of the unitary apportionment method, in contrasts to federal, and internationally accepted, use of the arms-length standard, creates a substantial risk of international multiple taxation. For example, if a U.S. subsidiary engages in transactions with its foreign parent (which otherwise engages in no U.S. business activity) on an arms-length basis and the U.S. subsidiary operates at a loss, no portion of the foreign parent's income would, under the arms-length standard, be subjected to federal income tax. At the federal level, therefore, there

would be no international double taxation because only the foreign country would subject that income to tax. Under the state unitary method, however, a portion of the foreign parent's income would be allocated to the U.S. subsidiary and would thus be subject to tax in the state. Accordingly, both the state and the foreign country would tax such apportioned income, thereby resulting in international double taxation of the same income. In this manner, the state unitary method frustrates the federal policy, consistent with international usage, of avoiding or mitigating international double taxation.[6]

To be sure, the application of the Illinois tax in this case does not, as the California tax in *Japan Line*, "creates multiple taxation in fact" (see 441 U.S. at 452 n.17). Indeed, the unitary method has produced a refund for Caterpillar, a fact which explains its support of Illinois' position here. But we believe that the foregoing considerations demonstrate that the Illinois tax would, in most cases, create a substantial risk of international multiple taxation that would be sufficient to invalidate the unitary method in the international context. It would nevertheless be understandable if the Court wishes to resolve the issue in a case with a more fully developed record in which the state tax can be shown in fact to impose multiple burdens. This course of action may be appropriate insofar as the Court has not decided "under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed

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[6]As we have pointed out (*supra*, page 3), the federal income tax law mitigates international double taxation through the foreign tax credit. See 26 U.S.C. (& Supp. III) 901 *et seq.* Under these provisions, foreign income taxes that are imposed on foreign source income that is also subjected to U.S. taxation can be credited against that U.S. tax liability. In marked contrast, the state unitary method at issue here has no comparable provision.

to interstate, commerce." *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 452 n.17 (emphasis in original). Accordingly, if the Court wishes to consider the question in this case in the context of a case involving multiple taxation in fact, it may wish to defer decision in this case and note probable jurisdiction in *Container Corporation of America* v. *Franchise Tax Board,* No. 81-523.

b. *Federal Uniformity.* Even assuming arguendo that there is an insufficient showing in this case that the Illinois unitary method creates a risk of international multiple taxation, the tax is still invalid because it impairs federal uniformity. Under *Japan Line,* a state tax is invalid if it prevents the federal government from "speaking with one voice" in international trade, "[I]f it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung* v. *Freeman,* 92 U.S. 275, 280 (1875).

As we have pointed out (*supra,* page 2), the United States and most foreign countries use the arms-length method of allocating income between corporations. Illinois' variant unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income. Indeed, the Secretary of the Treasury and the Secretary of State have recently received diplomatic communications from the Governments of Great Britain and Canada, complaining about the state unitary method and emphasizing its incompatibility with international practice (see Appendix, *infra,* 1a-9a). Similarly, as appellant points out (J.S. 20), all nine members of the European Common Market joined in a *demarche* emphasizing the incompatibility of worldwide combined reporting with internationally accepted rules and principles of the OECD. "The risk of re-

taliation by [foreign countries], under these circumstances, is acute, and such retaliation of necessity would be felt by the Nation as a whole" (footnote omitted) (*Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 453). In this respect, the amicus Union of Industries of the European Community (Br. 7-9) points out that the application of the state unitary method may violate certain treaties of friendship, commerce and navigation. See especially Article IX of the Convention with France which limits state taxation of French companies to income " 'directly related to their activities within those territories' " (Br. 9 n.12).

In sum, "the freedom of the States to formulate independent policy in [the] area [of commerce] may have to yield to an overriding national interest in uniformity" *Moorman Manufacturing Co.* v. *Bair, supra,* 437 U.S. at 280. "We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts." *Bremen* v. *Zapata Off-Shore Co.,* 407 U.S. 1, 9 (1972). The income taxation of multinational businesses is thus a matter that is subject only to a national rule conformable with the practice of nations or adopted pursuant to the President's authority "by and with the Advice and Consent of the Senate to make Treaties * * *" or Congress' power "[t]o regulate Commerce with Foreign Nations * * *." "[Illinois], by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 453.[7]

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[7]*Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. at 425, upon which the decision below relied (J.S. App. C18), has no bearing on this case. There, the Court held that a New York corporation having a place of business in Vermont could not object, on Commerce Clause grounds, to the imposition of a Vermont corporate income tax which allocated a portion of foreign source

3. If, as we submit, the Court concludes that the Illinois combined reporting requirement either: (a) creates a substantial risk of international multiple taxation, or (b) impairs federal uniformity in the conduct of foreign relations, that is the end of the matter, and the judgment below should be reversed. In those circumstances, the Illinois combined reporting method could not be constitutionally applied to any multinational group of corporations—a result we believe to be compelled by the Commerce Clause. If the Court concludes, however, that the record in this case is inadequate to support such a disposition, we urge it to defer resolution of the issue to another case which has a more fully developed record.

Whatever ruling it may render here, the Court should be aware that neither this case nor any case presently pending before it presents the issue in the context of a unitary business consisting of a U.S. subsidiary whose parent corporation is foreign. It may well be that the multiple tax burdens and the impairment to federal uniformity in international trade caused by the state apportionment method will be more easily demonstrated in a case involving a corporate group with a foreign parent. In that case, there will be, in addition to the considerations we have already pointed out, other burdens that the state unitary method will impose on international trade and foreign relations. For example, a foreign parent corporation with no direct U.S. activities would generally maintain its financial accounts according to local (*i.e.* foreign) accounting principles and in the local currency. Conversion of such accounts to conform to U.S. accounting principles and to the individual states' tax ac-

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dividend income paid by its foreign subsidiaries. The taxpayer, however, admitted that New York, as the state of commercial domicile, could tax such foreign-source dividends in full. Hence, *Japan Line* was not implicated because there was no issue of international multiple taxation (see 441 U.S. at 446-447, 448).

counting rules, as well as conversion of all entries into U.S. dollars (which are required for apportionment under the state unitary method), pose a severe administrative and financial burden on the foreign parent corporation and other foreign affiliates. Moreover, there will be further burdens on international trade resulting from the demands by state tax authorities that the foreign corporation produce and explain its records of business transactions that are entirely unrelated to activities within the United States. Accordingly, the Court should not decide this case on any ground that would foreclose any claims that may be raised in a future case involving the imposition of the combined reporting method to a group of corporations with a foreign parent.

CONCLUSION

For the reasons stated, the judgment of the Supreme Court of Illinois should be reversed.

Respectfully submitted.

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Supreme Court, U.S.
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No. 81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT
OF APPEAL OF THE STATE
OF CALIFORNIA, FOR THE
FIRST APPELLATE DISTRICT

APPELLEE'S BRIEF ON THE MERITS

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Vol. I of II

QUESTIONS PRESENTED:

The questions raised by the Arguments made in Appellant's Brief are:

1. Has appellant carried its burden of establishing on the record herein that due process clause of the United States Constitution prevents use of formula apportionment and requires refund of any amount of tax in issue because of claimed lack of a "unitary business" (App. Brief, Arg. II, pp. 40-49), or "distortion" and "extraterritorial taxation" (App. Brief, Arg. I(A,B) pp. 11-20.)

2. Has appellant carried its burden of establishing on the record herein that the commerce clause of the U.S. Constitution requires refund of any amount (and what amount of the tax in issue because of claimed "taxation of income also taxed by foreign countries"

(App. Brief, Arg. I(C) pp. 21-26), or claimed prevention of the federal government "speaking with one voice in regard to foreign policy" (App. Brief, Arg. I(D), pp. 27-36.)

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TABLE OF CONTENTS

	Pages
QUESTIONS PRESENTED	i - ii
STATEMENT OF THE CASE	1 - 38
A. FACTUAL DETERMINATIONS BY LOWER COURTS	2 - 3
B. FACTS CONTAINED IN THE COURT OF APPEAL DECISION SHOULD BE THE BASIS FOR THIS COURT'S ACTION	3 - 5
C. EVIDENCE PRESENTED AT TRIAL SUPPORTS THE FINDING OF UNITY	5 - 36
1. CCA's Subsidiary Structure	7 - 8
2. CCA's foreign Operations Staff	8 - 12
3. Technical Service Agreements Required CCA to Provide Broad Technical and Managerial Advice to the Foreign Subsidiaries	12 - 17
4. Formation of Subsidiaries	17 - 18
5. Continuous Personnel Coordination Exists	18 - 21

6.	Continuous Training of Subsidiary Personnel was in Fact, Provided By CCA	21 - 23
7.	Auditing and Financial Accounting Were Coordinated and Used to Assure that Foreign Subsidiaries Complied With CCA Policies	23 - 24
8.	Major Financial Assistance Was Provided Gratis by CCA to the Foreign Subsidiaries	24 - 25
9.	CCA Furnished Directly to and Obtained Machinery and Equipment for Its Foreign Subsidiaries	25 - 27
10.	CCA Provided Substantial Paperboard and Raw Materials for Its Subsidiaries and Assisted in Developing Local Sources	27 - 29
11.	CCA Provided Assistance to Its Foreign Subsidiaries in Sales of Packaging Products	29 - 31
12.	Subsidiaries Used CCA's Insurance Brokers	31

13. CCA Represents Its Foreign Subsidiaries to Be Part of Its Unitary Business to Its Stockholders and the Public 31 - 32

14. CCA's Separate Accounting Does Not Reflect Its Large Contributions to Its Foreign Subsidiaries 32 - 35

D. ADDITIONAL FACTS SHOW NO DENIAL OF DUE PROCESS 36 - 38

E. CCA SETS FORTH NO FACTS SUGGESTING VIOLATION OF THE COMMERCE CLAUSE IN ITS STATE OF THE CASE 38

SUMMARY OF ARGUMENT 39 - 44

ARGUMENT

I CCA HAS THE BURDEN OF ESTABLISHING UNDER CALIFORNIA PROCEDURAL LAW BY CLEAR AND CONVINCING EVIDENCE THAT IT HAS BEEN DEPRIVED OF CONSTITUTIONAL RIGHTS WHICH HAS RESULTED IN OVERPAYMENT OF A SPECIFIC AMOUNT OF TAX 45 - 56

A. The Unitary Question Should Be Considered On the Basis of the Facts Contained in the Court of Appeal Opinion 49 - 51

B.	If the Record is Reviewed for Evidence of Lack of Unity, All Inadequacies, Ambiguities and Inferences Must Be Resolved Against the Taxpayer-Appellant and All Presumption in Favor of Unity Applied	51 - 56
II	CCA'S FOREIGN SUBSIDIARIES ARE PART OF ITS UNITARY BUSINESS UNDER TESTS APPLIED BY THIS COURT	57 - 89
A.	The Due Process Requirements of Unity Should Be No Greater Than California's Contribution Test	60 - 61
B.	Woolworth and ASARCO Reinforce the Rule That an Activity is Part of a Unitary Business Unless it is a Distinct and Discrete Business Which Does Not Benefit the Whole	61 - 68
C.	CCA's Subsidiaries Are Not Discrete Businesses. They Are Part of Its Unitary Enterprise	68 - 83
D.	Intercompany Product Flow Is Not a Prerequisite to the Existence of a Unitary Business	83 - 87

E. Income of Foreign Subsidiaries Which are Part of a Unitary Business May Be Combined Without Violating Due Process 87 - 89

III CCA HAS NOT SHOWN DISTORTION BY THE FORMULA 91 - 108

A. Separate Accounting Data Does Not Impeach the Formula 91 - 99

B. Differing Wage Rates and Rates of Return Do Not Impeach the Formula 99 - 108

IV THE COMMERCE CLAUSE DOES NOT REQUIRE REVERSAL 109 - 131

A. Here No Tax is Imposed On Foreign Commerce 109 - 114

B. CCA has Not Proven Unconstitutional Double Taxation Here 114 - 121

C. CCA has Not Proven Interference In Violation of the Commerce Clause With Foreign Relations 121 - 131

V AMICI SUPPORTING APPELLANT SHOW NO UNCONSTITUTIONALITY 132 - 138

CONCLUSION 138 - 140

APPENDIX

Appendix A:

Management Theory:
Selected Excerpts A1 - A15

Administrative Organization
Prentice-Hall, Inc.
Englewood Cliffs, N.J.
1960, John Pfiffner and
Frank Sherwood A2 - A11

Management: Tasks,
Responsibilities, Practices
Harper & Row, New York 1974
Peter F. Drucker A11 - A15

Appendix B:

Exhibit D to Stipulation
of Facts --
Container Corporation of
America Former CCA
Employees Working for
Foreign Subsidiaries A16 - A19

Appendix C:

Source Variations Computed
on the Basis of Taxable
Income A20 - A24

Appendix D:

Caterpillar Tractor Co.,
et al v. Illinois Dept
of Revenue, et al and
Coca-Cola Co., et al
Intervenor, Illinois
Supreme Court No. 52818, 52828,
52903 (Argument I thereof) A25 - A52

Appendix E:

Excerpt from International Division of the Income Tax Base of Multinational Enterprise, Publ. Multistate Tax Commission, 1981, Geoffry John Harley A53 - A55

* * * * *

TABLE OF AUTHORITIES

	Pages
CASES	
ASARCO, Inc. v. Idaho State Tax Commission 50 U.S.L. Week 4952, ___U.S.___	62,63,67
Bass, Ratcliff & Gretton Ltd. v. Tax Commission (1924) 266 U.S. 271	83,86,95 111
Bd. of Education v. Jack M. (1977) 19 Cal.3d 691	52
Butler Bros. v. McColgan (1941) 17 Cal.2d 664, affd. (1942) 315 U.S. 501	19,77,84 95,96
California Liquor Dealer's Assn. v. Midcal Aluminum (1980) 445 U.S. 111	49
Denham v. Superior Ct. (1970) 2 Cal.3d 557	52
Edison California Stores v. McColgan (1947) 30 Cal.2d 472	58
El Dorado Oil Works v. McColgan (1950) 34 Cal.2d 731	46,53
Exxon Corp. v. Wisconsin Dept of Revenue (1980) 90 Wis.2d 700, affd. 447 U.S. 207	58,77,81,85 95,89,91-93

F.W. Woolworth v. Taxation and Rev. Dept of New Mexico 50 U.S.L.Week 4957, ___U.S.___ 62,64-65 66,67

Flying Tiger Line v. St. Bd. of Equalization (1958) 157 Cal.App.2d 85 45

General Motors Corp. v. Washington (1964) 377 U.S. 436 54

Hall v. Franchise Tax Board (1966) 244 Cal.App.2d 843 45

Honolulu Oil Co. v. Franchise Tax Board (1963) 60 Cal.2d 417 59,86

Japan Line Ltd, v. County of Los Angeles (1979) 441 U.S. 434 109,112,113 114,115

John Deere Plow Co. of Moline v. Franchise Tax Board (1951) 38 Cal.2d 214 app. dism. 343 U.S. 939 100

Mae See v. North American Acc. Ins. Co. (1923) 190 Cal. 421 52

McIntyre v. Doe & Roe (1954) 125 Cal.App.2d 285 52

Michelin Tire Corp. v. W. L. Wages (1976) 433 U.S. 276 130

Mobil Oil Corp. v. Comm'r of Taxes (1980) 445 U.S. 425	61,85,87,88 113-114, 116 120-121,122-123
Norfolk & Western RY Co. v. No. Carolina (1936) 297 U.S. 682	46,53,103
Norton Co. v. Dept of Rev. State of Illinois (1951) 340 U.S. 534	54
Pacific Fruit Express Co. v. McColgan (1944) 67 Cal.App.2d 93	46
Shell Petroleum N.V. v. Mary Ann Graves, et al No. C814302 (N.D.Cal)	134,136
Sullivan v. United States (1969) 395 U.S. 169	124
Sumitomo Shaji America, Inc. v. Avagliano (Jun 15, 1982) 50 U.S.L.Week 4643	128,129
Superior Oil Co. v. Franchise Tax Board (1963) 60 Cal.2d 406	59,86
Time, Inc. v. Firestone (1976) 424 U.S. 448	49
Underwood Typewriter Co. v. Chamberlain (1920) 254 U.S. 113	83,111
Washington Rev. Dept. v. Stevedoring Assn. (1978) 435 U.S. 734	130,131

Wisconsin v. J.C. Penney, Co.
(1940) 311 U.S. 435 130,131

CONSTITUTIONS

U.S. Constitution, Art 1,
§ 8, cl. 3 121

STATUTES

California Evidence Code
§§ 500, 550 45

Internal Revenue Code
§§ 951-964 98

RULES OF COURT

U.S. Supreme Court Rules
rule 34.1(g) 48

Calif. Rules of Court,
rule 29, ¶ b 50

ARTICLES/REPORTS

Allocation of Income in State
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No. 81-523

IN THE SUPREME COURT OF THE UNITED STATES

October Term 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA FOR THE
FIRST APPELLATE DISTRICT

APPELLEE'S BRIEF ON THE MERITS

STATEMENT OF THE CASE

Appellant's statement of the case omits material facts, misstates others, and ignores the factual determinations made by all lower courts which agreed that CCA's foreign subsidiaries were part of

its unitary enterprise. It should be disregarded; this case should be decided upon the facts set forth hereinafter.

A. FACTUAL DETERMINATIONS BY LOWER COURTS

Both California's trial court and Court of Appeal found on the evidence in the record that plaintiff's foreign subsidiaries were part of its unitary business. CCA (plaintiff and appellant) did not request findings of fact from the trial court; accordingly, under California law and procedure, all facts and inferences in support of the judgment are deemed to have been made by the trial court. The evidence before the trial court on the question of unity consisted of stipulated facts (primarily J. A. pp. 5-82) and exhibits offered separately in evidence (including technical service agreements,

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annual reports, etc.) numbered A through K.[1]

B. FACTS CONTAINED IN THE COURT OF APPEAL DECISION SHOULD BE THE BASIS FOR THIS COURT'S ACTION

The California Court of Appeal recited in its opinion the facts which it felt were material thereto. Under appropriate appellate procedures, this case should be resolved on the basis of those facts, rather than by an independent review by this Court of the evidence in

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1. At trial there was also testimony offered both orally (J.A. pp. 118-223) and by stipulation (J.A. pp. 83-117) pertaining primarily to arguments of distortion and double taxation. Appellant's Statement of the Case refers to none of these facts. It is required by Rule 34.1(g) to include in its Statement of the Case everything material to consideration of the questions presented. Appellant's failure to do so should preclude consideration thereof on this appeal. Accordingly, appellee will not discuss such facts in its statement of the case.

the record.[2/]

The facts considered to be material by the California Court of Appeal are contained in its opinion (Juris. Stmt., Appen. A; see also 117 Cal.App.3d 988; 73 Cal.Rptr. 121). These facts are

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2. California Rules of Court, rule 29 provides in part:

> (b) On petition for hearing the Supreme Court will not examine the record for error unless the petition shows that substantial issues of. . . fact were incorrectly stated . . . in the opinion of the Court of Appeal and that such issues were . . . set forth in a petition for rehearing in the Court of Appeal."

While Appellee contends in a footnote to its statement of the case (App. Brief (hereinafter AB) p. 2, fn. 1), that the California Court of Appeal inaccurately stated three facts, it fails to show that it pointed out to any such alleged errors in a petition for rehearing. Absent contesting the accuracy of the factual statement by the Court of Appeal on a Petition for Rehearing, the California Supreme Court was bound by the factual statements of the Court of Appeal, and this Court on an appeal from the final state decision (by the Calif. Supreme Court in denying a hearing), should be similarly bound.

incorporated by this reference. (See J.S. pp. A-1 - A-26.)

C. EVIDENCE PRESENTED AT TRIAL SUPPORTS THE FINDING OF UNITY

A summary of the evidence presented at trial court which establishes that plaintiff's foreign subsidiaries are part of its unitary business includes the following:

This action involves a suit for refund of franchise taxes paid under the California Bank and Corporation Tax Law based upon appellant's activities during 1963, 1964 and 1965. (J.A. p. 6, ¶ 8.) The stipulated facts unless otherwise noted, pertain to the years 1963-65. (J.A. p. 6, ¶ 6.)

Container Corporation of America (CCA) was a Delaware corporation with principal offices in Illinois. (J.A. p. 6-7, ¶ 9.) CCA is an "integrated producer" of paperback packaging, producing paperboard

and manufacturing paperboard packaging products, especially corrugated and solid fiber shipping containers. (J.A. pp. 17-18.) ¶¶ 29, 30.) CCA operated throughout the United States and also made sales to other countries through plant salesmen which were based in or traveled to such countries, primarily Canada and Puerto Rico. (J.A. pp. 18-19, ¶¶ 31, 32.) CCA is decentralized, organized with a single regional Vice President responsible for all phases of operation in his region. (J.A. pp. 13-14, ¶ 24.)

CCA had approximately $30 million in sales, $10 million in payroll and $15 million in property in California during each of the years on appeal. (See J.A.:Exhibits [hereinafter J.A.:Ex] pp. 2, 4, 6 "CCA California Factors.") CCA treated, and does not now contend otherwise, that its own operations were a

unitary business; it objects, however, to including any of its foreign subsidiaries in its unitary business.

1. CCA's Subsidiary Structure

CCA commenced operations through subsidiaries by forming its own subsidiaries in Colombia (1944), Venezuela (1953), Germany (1955) and Italy (1958), and by acquiring an existing company in Mexico (1944) and in Holland (1958). All these subsidiaries were engaged in some aspect of the same paperboard/packaging business which CCA engages in. (J.A. pp. 14-15,¶ 25.) CCA also had a Panama holding company, and an inactive Austrian subsidiary. (Ibid.) "Carton Internacional, S.A." the holding company had no property, no payroll and no sales, but nonetheless was assigned about $1.5 million of net income annually under CCA's separate accounting procedures. (J.A.Ex pp. 3,5.)

Most subsidiaries were wholly owned by CCA. (J.A. pp. 14-15.) Minority interests were created in some to obtain more favorable business considerations and minimize antagonism of foreign countries toward United States owned subsidiaries. (J.A. pp. 14-16, ¶¶ 25, 27.) When several subsidiaries existed within a country, they operated as an integrated unit with one dominant subsidiary coordinating the operations of all the subsidiaries based within that country. (J.A. pp. 31-32, ¶ 63.)

2. CCA's Foreign Operations Staff

CCA maintained a "foreign operations staff" consisting of a "Senior Vice President of Overseas Operations", a Vice President of European Operations," a Vice President of Latin American Operations," a controller, and an attorney. These three individuals had other duties and responsibilities. (J.A. pp. 65-67, ¶ 126-130.)

Mr. Green, the Senior Vice President of Overseas Operations, made decisions regarding the overall overseas operations and visited each country where CCA had subsidiaries once or twice a year." (J.A. pp. 65, ¶¶ 126-127.) His primary functions were to "oversee CCA's foreign subsidiaries and communicate requirements for compliance with CCA's standards for professionalism, profitability and ethical practices." (Id., at p. 66.)

In addition Mr. Green (as general counsel) and another attorney on CCA's staff handled CCA's international legal affairs. (J.A. p. 65.) Mr. Ulvaeus, CCA's "Vice President of European Operations," earlier worked for CCA in sales, then for a European subsidiary before being promoted to this position. He had "responsibility for all European subsidiaries which included eighteen plants in three countries," and was simultaneously

the chief operating officer of one of the European subsidiaries. (J.A. p. 66, ¶ 128.)

Earl Kauffman worked for CCA from 1933 to 1954 when he "transferred to Carton de Venezuela"; he became CCA's Vice President of Latin American Operations" in 1963. He had "responsibility for all Latin American operations which included 25 plants in three countries." (J.A. p. 66.) Both Ulvaeus and Kauffman were on CCA's payroll and were also paid by foreign subsidiaries to the extent that they performed functions for them. They acted as "steward for CCA's foreign interests, and liaison between the parent and subsidiaries in their respective localities." They "were involved with major problems and long-range decisions." Each reported directly to Mr. Green, and the foreign operations staff "presented studies and make recommendations with

respect to foreign activities to CCA's management committee and board of directors." (Capital appropriations, including acquisitions of new equipment, were considered major policy matters which had to be reviewed and approved by CCA management in Chicago.) (J.A. pp. 39-40, ¶ 74.)

The Foreign Operations Staff spoke for CCA in dealing with its subsidiaries. Through them CCA held local management strictly responsible for its performance. Generally, day-to-day business decisions were left in all cases by CCA to its local managers, believing it impossible to impose such responsibility on managers without giving them commensurate authority in order to preserve morale and long-term performance. (J.A. pp. 67-68, ¶ 130.) (This appears to be the identical decentralized management approach followed

in operating its concededly unitary, but similarly decentralized United States operations.[3/]

The vice chairman of CCA's board of directors, Mr. Spachner, was involved together with Mr. Paepcke, former President of CCA, in the early planning and administration of foreign operations. (J.A. p. 68, ¶ 131.)

3. Technical Service Agreements Required CCA to Provide Broad Technical and Managerial Advice to the Foreign Subsidiaries

CCA had formal technical service agreements with its subsidiaries in Mexico, Netherlands, and Germany. (J.A. p. 74, ¶ 144; J.A.:Ex pp. 9-33 - Exh. F.) The agreements require CCA to provide to the subsidiaries all assistance required by

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3. See Appendix A for a discussion of decentralization as a management philosophy.

the subsidiary, whether technical or managerial, industrial or commercial or otherwise, related to their mutual paperboard/packaging business.[4/] There were no technical service agreements in

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4. The agreements with the European subsidiaries generally provided as follows:

> The subsidiary engages in the "same industries" as CCA and wishes to "partake of the experiences accumulated by CCA" "[i]n order to develop its business. . . ." (J.A.:Ex p. 9.) CCA agrees
>
> ". . .to provide advice and consultation . . . concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting . . . to render any other assistance which the subsidiary may require in connection with any aspect of its industrial or commercial operations."
>
> ". . . CCA will furnish [subsidiary] with all technical bulletins and other material that [CCA] uses in the United States and that [subsidiary] may require from time to time. [CCA] will undertake to answer [subsidiary's] requests for assistance in these areas by correspondence as explicit as [subsidiary] may require,

Colombia and Venezuela because blanket agreements are not allowed by these countries; however, CCA did perform identical services

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fn. 4 (cont'd)

> and besides, at the request of [subsidiary] it shall send qualified personnel to Germany or train employees of [subsidiary]."
>
> "[Subsidiary] shall not have the right to pass the informations received from [CCA] on to third parties, but only to use it for its own ends." (J.A.:Ex pp. 9-10.)

CCA's technical service agreements with Mexico specifically provide as follows:

That CCA has within its industrial, administrative and commercial personnel, the experts necessary to furnish technical assistance and is willing to do so,

> "For the efficient operation of the above-mentioned industrial plants, [subsidiary] requires the technical assistance which it has requested from [CCA] as a consequence of their close commercial relationship. . . ." (J.A.:Ex pp. 13-14.)

CCA binds itself to render to the subsidiary technical assistance for their efficient operation of its present and future paperboard/container activities;

for these subsidiaries. (J.A. p. 74, ¶ 144.)

The "fair market value of many of the services cannot be ascertained,"

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fn. 4 (cont'd)

and agrees to furnish

> ". . . technical assistance as far as concerns the purchase of machinery and raw materials, the supervision of production methods and and the improvement of same in accordance with CCA's technical progress, the information of such raw material or finished products markets as may be of interest to it, as well as any other assistance which it may require in connection with any aspect of its industrial or commercial operations."
>
> [including]
>
> ". . . information, market quotations, sources of supply, industrial methods, all this by writing and as explicit as [subsidiary] may require, and besides, at the request of [subsidiary] it shall send to Mexico all the technicians or specialized personnel working under the services of CCA which [subsidiary] may require from time to time." (J.A.:Ex p. 14.)

All such information shall be considered confidential and subsidiary may not pass it on to other parties, but only use it for its own ends. (J.A.:Ex p. 15.)

therefore, charges were often computed on the basis of an apportionment of overhead of the relevant staff department (J.A. p. 75), (or under the technical service agreements as a percentage of trade sales or a fixed fee.) (See J.A.Ex pp. 11, 21.) Some of these charges were unrecoverable because of restrictions on payments to foreign affiliates and therefore, consisted merely of book entries. (J.A. pp. 74-75, ¶ 144.)

CCA provided market research assistance under the technical services agreement. (J.A. p. 33.) CCA's design laboratory did work for Mexican subsidiaries, and a "sophisticated design and market research facility" operated by Europa Carton provided services to all European subsidiaries. (J.A. p. 34.) CCA provided sample packages to its subsidiaries and assistance to subsidiaries in establishing design laboratories or expanding functions

of existing facilities. (J.A. pp. 34-35.) CCA provided suggestions as to the use of market research techniques and regarding "general problem solving procedures." (J.A. p. 35.) Generally, such assistance was given upon request.

4. Formation of Subsidiaries

When CCA formed its foreign subsidiaries it trained local personnel to assume major production responsibilities; key individuals were sent to the United States to study manufacturing practices in CCA plants, and CCA employees were sent as a complement to local personnel for the first few years, in addition to CCA's initial involvement with technology and personnel training, it also supplied the necessary equipment and a portion of raw material requirements until they could be locally developed. (J.A. p. 42, ¶ 79, discussing Colombia.) CCA formed its own subsidiaries

in all of the countries in which it had operating subsidiaries, except the Netherlands.

5. Continuous Personnel Coordination Exists

In addition to the vice presidents of CCA located in Europe and Latin America (to supervise and advise the foreign subsidiaries), other management personnel overlap and coordination existed between CCA and its foreign subsidiaries. Officers of CCA appear to have been both on the board of directors of each of the foreign subsidiaries, and served as officers for a number of the subsidiaries. (Exh. E to Stip. of Fact, in Record (hereafter "Ex.")

More importantly, CCA provided assistance to the foreign subsidiaries in finding employees for them with specific qualifications which were not available in the foreign countries. (J.A. p. 62, ¶ 120.) These people were first sought from within CCA.

Between 1958 and 1963, nineteen key management and supervisory personnel were so transferred. (Ex. D - Appen. B hereto.) An example of transfer of CCA management to a subsidiary is Russell Wilson who worked his way to General Supervisor in CCA, thereafter transferred to Venezuela in 1962, working in production and general management until 1967 when he became director of Venezuela's marketing operation. (J.A. p. 50, ¶ 94.) Another example was the transfer in 1961 of Frank Angeles, a designer in CCA's design laboratory to the Mexican subsidiary as "Art Director", which led to the creation of the subsidiary's design and market research center. (J.A. pp. 54-55, ¶ 106.)

In addition, general managers of divisions and a divisional director of manufacturing in Venezuela transferred from CCA in the early 1950's. (Ibid.) There were additional CCA employees who

transferred to foreign subsidiaries (ibid); CCA does not know whether the list (Ex. D) is complete or there were even more. (J.A. p. 62, ¶ 120.)

These employees wish to retain retirement and other employment benefits of CCA while working at the foreign subsidiaries. (J.A. p. 64-65, ¶ 124(c).) These transferees remained on CCA's payroll and retained all benefits of employment with CCA (except for a common stock bonus plan). Seven such employees were granted options under CCA's stock plan of 1956, indicating that they were considered to be key and important employees of CCA itself. (J.A. p. 65, ¶ 124(d).)

CCA's accounting department maintained the foreign employees on CCA's payroll, and was reimbursed for its services in payroll costs, but there is no showing that costs to CCA of options granted under

the stock plan or retirement or other benefits were not absorbed by CCA. (J.A. p. 65, ¶ 125.) Nor is there any suggestion that CCA did not absorb the costs of its "foreign operations staff" discussed above, or the unmentioned secretarial, accounting and clerical personnel who necessarily assisted the foreign operations vice presidents, attorneys and controller who made up the foreign operations staff. (See J.A. pp. 65-67.)

6. Continuous Training of Subsidiary Personnel was in Fact, Provided by CCA

After the initial extensive training provided during the formative years, CCA continued to be available at all times to provide additional training as needed to its foreign subsidiaries. Employees of (1 to 3 at a time) CCA's foreign subsidiaries made an average of 10 to 12 visits per year to CCA for

periods from two to six weeks each, "to familiarize themselves with the methods of operation of CCA." These visits were primarily by employees "in control functions" and occasionally plant managers. (J.A. p. 69, ¶ 132.)

In addition to transferring employees directly from CCA to foreign subsidiaries, Americans (most in management positions) who were hired by CCA to become (or otherwise became) employees of CCA's foreign subsidiaries, were also permitted to be placed on CCA's payroll. (See Ex. D.)

The frequency with which CCA technical employees visited foreign subsidiaries, and the nature of the activities and assistance given on such visits does not appear to be reflected in the record, accordingly, CCA has failed to carry its burden of showing that no substantial technical service and assistance was

provided by it under the technical service agreements and otherwise.

7. Auditing and Financial Accounting were Coordinated and Used to Assure that Foreign Subsidiaries Complied With CCA Policies

Monthly financial statements, occasional local plant financial reports and detailed annual financial statements were furnished to CCA from foreign subsidiaries. (J.A. p. 71, ¶ 135.) Also long-range three-year budget forecasts of capital projects were submitted by the subsidiaries to CCA and reviewed annually. Capital projects for each year were reviewed on a quarterly basis by Container's management committee and board of directors. When foreign subsidiaries borrowed funds on their own, there was some review by CCA management. (J.A. p. 70, ¶ 134.)

The same certified public accounting firm audited CCA and all subsid-

iaries, except Holland and Germany. (J.A. p. 72 ¶ 138.) Although accounting procedures and methods were not standarized, "CCA worked toward achieving the most efficient systems and procedures possible." (J.A. p. 72, ¶ 139.) Financial statements and information submitted by the foreign subsidiaries were adequate to determine the subsidiaries' condition, as otherwise CCA "would have been forced to take a more active role." (J.A. p. 72, ¶ 137.)

8. Major Financial Assistance Was Provided Gratis by CCA to the Foreign Subsidiaries

In addition to the substantial equity contributed by CCA, it also made substantial loans directly to its foreign subsidiaries[5/] and guaranteed a substantial portion of loans by third parties to the

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5. $4,000,000 of long-term debt and $3,000,000 of short-term in 1963 and 1964. (J.A. pp. 69-70,¶176.)

foreign subsidiaries.[6] (J.A. pp. 69-70, ¶ 173.) Through these means CCA was directly involved in over one-half of the foreign subsidiary financing.

CCA has not established that it received any consideration for its guarantees or what rate of interest it was paid on its direct loans.[7]

9. CCA Furnished Directly to and Obtained Machinery and Equipment for its Foreign Subsidiaries

Normally, whenever CCA upgraded its American processes, it would initially

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6. Guarantees covered approximately one-third of such loans, or between $2.8 million and $3.7 million. (J.A. pp. 69-70, ¶ 173.)

7. An examination of the federal Form 2952 (Ex. J) discloses that CCA received total interest payments from foreign subsidiaries of approximately $19,900 in 1963, $95,000 in 1964 and $59,500 in 1965 on outstanding balance of $7,704,987, $7,155,714 and $3,223,371 respectively. (J.A. p. 69, ¶ 133.) (A return of .003, .013 and .018 respectively.)

attempt to transfer its machinery or equipment which was being replaced to a subsidiary. If a subsidiary could use the machinery or equipment, the subsidiary normally paid CCA book value (cost minus depreciation) plus the costs of preparation and shipping. (J.A. pp. 76-77, ¶ 147.)[8/]

CCA's purchasing department also purchased (from outside sources) approximately 90% of the equipment obtained by the Latin American subsidiaries, and 10% of that going to Europe. CCA so purchased approximately five to seven million dollars' worth of machinery and equipment per year for subsidiaries. CCA's purchasing department was paid a fee which was

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8. Even at depreciated book value CCA's Mexican subsidiaries purchased over $20,000 and its Colombian subsidiaries, over $40,000 of used equipment in 1964. The amounts of such purchases in 1963 are not available, and thus must be presumed to be substantial since CCA carries the burden of proving that they were not. (J.A.:Ex p. 8.)

"somewhat" less than what independent assistance in obtaining this (mostly American) machinery and equipment would have cost the foreign subsidiaries. (J.A. pp. 7, ¶ 148.)

10. CCA Provided Substantial Paperboard and Raw Materials for its Subsidiaries and Assisted in Developing Local Sources

Because of the bulk, weight and transportation costs of raw materials, paperboard and products of the container industry, use of local raw material sources is required for economic, efficient manufacturing wherever possible. Thus, the furnishing of even small amounts of raw materials or paperboard from the United States to manufacturing plants in Europe or Latin America would not have occurred unless it had been important to the function of a foreign subsidiary to incur the substantial transportation costs.

The amount of direct sales by CCA to its foreign subsidiaries totalled an average of over $1 million per year. (J.A.:Ex pp. 2, 4, 6; also J.A. p. 73, ¶ 141.) In addition to furnishing its own product to its foreign subsidiaries, CCA purchased paperboard from third parties to be forwarded to its foreign subsidiaries. The extent of such assistance is unknown, but for the three years subsequent to this period, the amounts averaged about six million dollars per year. (J.A. p. 74, ¶ 143.)[9/]

In addition, CCA, its Colombian subsidiary, and the Colombian government, worked together in a joint venture to develop a special pulping process

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9. J.A.:Ex, Exhibit A-8 sets forth the amount of such purchases as a percentage of cost of goods sold (COGS). Since COGS includes labor and other costs, the percentages computed significantly understated the percentage of purchased goods acquired from, or through, CCA.

(J.A. p. 81, ¶ 158) to enable the Colombian subsidiaries to use local hardwoods rather than being dependent upon the more expensive imported wood pulp. (See J.A. pp. 44-45, ¶ 84.)

11. CCA Provided Assistance to Its Foreign Subsidiaries in Sales of Packaging Products

The end products which CCA and its subsidiaries manufacture, are not sold by them to the general public, but to businesses which have products needing containers or packages. CCA has not established that advertising[10] or sales

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10. In Europe no advertising was done in some years when advertising was done, "programs were very modest." (J.A. p. 59, ¶ 117, 118.) Mexico did very little advertising. (J.A. p. 55, ¶ 107) There is no mention of any advertising in Colombia, where CCA's subsidiaries had very little competition. (J.A. p. 47, ¶ 88.) In Venezuela an unknown amount of advertising was done under "marketing" as a staff function of the manufacturing operation. (J.A. p. 50, ¶ 93.) In Venezuela a director of marketing, division general manager and at least ten other supervisors and managers were transferred from, and on the payroll of CCA. (Ex. D - Appen. B hereto.)

departments are significant (let alone important or essential) to the efficient operation of business. The foreign subsidiaries made sales in their countries to other United States companies such as Colgate, Proctor and Gamble, Kleenex, Vicery, Oster, Pepsodent, Johnnie Walker, or to their foreign subsidiaries. (J.A. p. 32, ¶ 64.) CCA uniformly recommended its foreign subsidiaries to United States customers who inquired of CCA about obtaining packaging in foreign countries. (J.A. p. 33.) CCA assisted in the negotiation of at least one contract for a foreign subsidiary. (Ibid.) This was for production of bannana boxes, a product which (together with a multi-wall bag), accounted for 15% of the Colombian gross

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fn. 10 (cont'd)

The packaging products sold in Latin America were more basic; rigorous competition did not exist as in the United States. (J.A. p. 47, 50, 54, 37.)

sales. CCA has not established that similar assistance was not provided to other foreign subsidiaries, or that any payment was received by CCA for such negotiation assistance, or the referral of customers from the United States.

12. Subsidiaries Used CCA's Insurance Brokers

CCA and its Colombian and Venezuelan subsidiaries obtained insurance through the same primary broker; the Mexican subsidiaries obtained some insurance from one of CCA's brokers, and since 1967, all subsidiaries have used the same insurance agent as CCA. (J.A. p. 78, ¶ 149.)

13. CCA Represents its Foreign Subsidiaries to be Part of its Unitary Business to its Stockholders and the Public

CCA's annual reports clearly show that it considered its entire worldwide operations, including the foreign subsidiaries here in issue, to be part of a

single organization and operation. In its representations of the nature of its business to the public it did not publicly hold any of the foreign subsidiaries out to be "separate or discrete" business which were not integrated into its own paperboard and packaging operations throughout the world. (See Exh. I, see also Speech by CCA's President - Exh. H.)

14. CCA's Separate Accounting Does Not Reflect its Large Contributions to its Foreign Subsidiaries

The fair market value of many of the services provided by CCA to its foreign subsidiaries "cannot be ascertained." (J.A. p. 75, ¶ 144), and CCA has made no effort to show that the payments in any way approached the benefit to the subsidiaries.

CCA's separate accounting procedures simply do not accurately reflect the substantial contributions by it to its foreign subsidiaries which substantially

enhanced their profit on their separate books, but which were in fact due to assistance provided by CCA. These contributions include the following:

(1) Over half of the loans to the subsidiaries were made directly or guaranteed by CCA, with only limited interest payments on the lease and no payment for the guarantees. (See pp. 24-25, supra.)

(2) CCA sold its used equipment at book, not fair market, value to the subsidiary, and obtained equipment for subsidiaries without charging "arms length" brokerage fees.

(3) CCA employed, at its own expense, an international department which included a senior vice president, two vice presidents, an attorney and controller (undoubtedly together with substantial support staff), to oversee and advise the foreign subsidiaries.

(4) Other CCA officers and staff spent substantial time and expense in reviewing capital addition proposals by the foreign subsidiaries and expansion and development plans in various foreign countries. Experienced personnel were transferred by CCA to subsidiaries' key management positions when the subsidiaries were unable to obtain them locally without payment except salary reimbursement.[11/]

(5) There is no evidence that CCA received remuneration for its investment in the joint venture designed to develop the hardwood pulping process for the benefit of its Colombian subsidiaries.

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11. The success of the foreign subsidiaries, particularly during formation, without these key personnel is doubtful. The enormous benefit to the subsidiaries of such transfers can hardly be measured by the salaries paid by the subsidiaries. (Such persons retained other non-salary CCA benefits; there is no evidence that CCA was reimbursed for these other benefits, including stock options.)

(6) There is no evidence that CCA received any remuneration under its separate accounting for its referral of customers to its foreign subsidiaries or the negotiation of the bannana box contract or other contracts.

(7) The mere fact that the individual foreign subsidiaries were part of a world-wise experienced and reliable organization headed by CCA, itself gave companies with whom the foreign subsidiaries dealt, security as to the reliability of the foreign subsidiaries and thus, undoubtedly gave them a better bargaining position in obtaining financing and customers and brought them business at more advantageous rates and prices than could have been obtained had the foreign subsidiary been attempting to compete all by itself without the technical service agreements and financial backing provided by CCA.

D. ADDITIONAL FACTS SHOW NO DENIAL OF DUE PROCESS

CCA has failed to establish in the evidence (let alone set out in its Statement of the Case) facts which show that California's formula taxes income out of all proportion to CCA's unitary business activities here. On the contrary, the evidence shows that even using the inaccurate[12/] figures used in CCA's argument the average difference between the almost 7% of its worldwide income which it concedes is taxable by California and the income taxed by California here is less

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12. See Appendix C for an analysis of their relevancy and accuracy. The numbers presented by CCA at AB, page 16 improperly use "book" amounts rather than figures actually used for tax purposes.

than .01%.[13/]

CCA has provided no evidence that these slight increases in the income apportioned to California exceeds its allocable share of the substantial benefits provided by CCA to its foreign subsidiaries for which it did not receive . . .

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13. CCA suggests (AB, p. 16) that if only CCA's own activities in the United States, Canada and Puerto Rico are combined, the income which CCA apportions to California is $2.9 million in 1963, $3.1 million in 1964 and $2.9 million in 1965, whereas if the foreign subsidiaries are considered part of the unitary business, California will be permitted to tax $3.1 million in 1963, $3.6 million in 1964 and $3.5 million in 1965. Thus, CCA concedes that California can properly tax a portion of its worldwide income amounting to .0742 in 1963, .0680 in 1964 and .0608 in 1968 of CCA's worldwide net income as reported to the United States government adjusted for California tax purposes. California's worldwide apportionment formula increases these percentages by only .0064 in 1963, .0095 in 1964 and .0119 in 1965. (Computations are based on figures in AB, p. 16; J.A.:Ex p. 7.)

fair market value in return.[14] CCA has proven no distortion.

E. CCA SETS FORTH NO FACTS SUGGESTING VIOLATION OF THE COMMERCE CLAUSE IN ITS STATEMENT OF THE CASE

CCA sets forth no facts in its Statement of the Case which suggest that California's three-factor formula as applied to CCA here, creates double taxation or in any manner violates the Commerce Clause of the United States Constitution. Thus, CCA should be limited under Rule 34.1(g) to the argument that formulary apportionment inherently violates the Commerce Clause, i.e., without regard to any facts.

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14. As is shown by Appendix C, using tax figures, the differences would be even less. Also under Subpart F of the Internal Revenue Code, U.S. income from the foreign subsidiaries was increased by an average of over 2.5 million dollars in 1964 and 1965. (J.A.:Ex, p. 7.)

SUMMARY OF ARGUMENT

CCA argues that the judgment below denying it a refund of taxes should be reversed because the formulary apportionment method by which California calculated the tax violates both the due process and commerce clauses of the United States Constitution.

This appeal is from a determination of the California courts, and accordingly, factual determinations are governed and the factual inquiries on appeal are limited by California procedural law as well as rules of this Court. There is no strong presumption of unity because CCA and its subsidiaries engage in the same type of business. CCA has the burden of proving unconstitutionality by clear and convincing evidence. All facts not clearly stipulated to be true are determined against appellant taxpayer who must prove

not only that the state's method of calculation was improper, but also the proper amount of the tax.

The "linchpin" of formula apportionment is the unitary concept; that where a business is "unitary" formula apportionment may be used; a business is not unitary only when the business activities outside the taxing state are a "discrete" or entirely separate business completely disconnected from the business activities in the taxing state. CCA has failed to establish that its foreign subsidiary activities are not part of its unitary business. CCA provides technical and management expertise, training, machinery and equipment, key personnel, direct loans and loan guarantees, and even some raw materials and sales assistance. Through an international department, CCA oversees the foreign operations and controls their development, budgets and

capital expenditures.

CCA has not proven that these substantial contributions by CCA to the profits of the subsidiaries are reflected in their separate accounting records at fair (or arm's length) value. Some, CCA concedes, cannot be valued at all; some were provided without any charge. This is the precise situation which calls for formula apportionment.

CCA asserts that the formula denies due process by distorting income, because (1) it differs in result from the federal tax measure, (2) there are differences in wage rates and (3) higher return on investment is expected from foreign operations. Due process places the burden on the taxpayer to prove by "clear and cogent evidence" that extraterritorial values are being taxed. CCA's arguments are primarily based upon

its separate accounting approach which clearly apportions insufficient income to U.S.A. Its wage argument ignores the interdependency of all three factors in the formula and is not supported by proper material facts. CCA has not shown that California has taxed a palpably excessive amount of its income, and has shown no due process violation.

CCA asserts Commerce Clause violations based upon Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434 (hereinafter "Japan Line") discussion of (1) double taxation and (2) need for federal "one voice" in foreign relations. No Commerce Clause violatives are proven.

The Japan Line discussion of double taxation is not applicable to income taxation of a domestic corporation like CCA; nor to apportionment of income of a unitary business. Taxation of the same

income at both state and federal level is proper. Evidence properly before this Court establishes neither actual, nor a substantial risk of constitutionally prohibited double taxation.

The facts properly before this Court do not establish any conflict between California's "combined reporting" of unitary income by formula apportionment and any U.S. government policy on foreign relations. On the contrary, during the period in issue here (1963-1965), all expressed federal policy permitted, and in no way disapproved, use by the states of formula apportionment. Even those who recently have spoken out against use of formula apportionment which includes a totally foreign business whose only contact with U.S.A. is through ownership of an American subsidiary have not objected to formula apportionment where the taxpayer is a domestic American corporation part

of whose unitary enterprise reaches into a foreign country through either a division or a subsidiary. California's tax here interferes with no federal foreign relations.

CCA has not established any due process or commerce clause violations. The judgment should be affirmed.

* * * * *

ARGUMENT

I

CCA HAS THE BURDEN OF ESTABLISHING UNDER CALIFORNIA PROCEDURAL LAW BY CLEAR AND CONVINCING EVIDENCE THAT IT HAS BEEN DEPRIVED OF CONSTITUTIONAL RIGHTS WHICH HAS RESULTED IN OVERPAYMENT OF A SPECIFIC AMOUNT OF TAX

This is an appeal from a decision from the California courts denying refund of taxes as being overpaid. Under California law, CCA as plaintiff in an action for refund has the burden of proof; the absence of evidence on a fact necessarily leads the court to make a factual determination contrary to CCA's position. (See Flying Tiger Line v. State Bd. of Equal. (1958) 157 Cal.App.2d 85, 99; Hall v. Franchise Tax Board (1966) 244 Cal.App.2d 843, 848; Cal. Evid. Code, §§ 500, 550.) In California formulary apportionment carries "the presumption of constitutionality

which attaches to all legislative acts. (El Dorado Oil Works v. McColgan (1950) 34 Cal.2d. 731, 744.) California follows the rule enunciated by the United States Supreme Court that to rebut the presumption that the formula produced a fair result "the burden is on the taxpayer to make oppression manifest by clear, cogent evidence." (Ibid; Norfolk and Western RY Co. v. North Carolina (1936) 297 U.S. 682, 688.) In California a taxpayer must not only show that taxing agency used an improper method of calculation, but also must establish a proper amount of taxes; the taxpayer must show "that more taxes have been exacted than in equity and good conscience and should been paid. (ElDorado Oil Works, supra, p. 744; Pacific Fruit Express Co. v. McColgan (1944) 67 Cal.App. 2d 93, 96.)

Here both the trial court and

the court of appeal in California determined all factual questions in favor of appellee Franchise Tax Board, (sometimes FTB).

The evidence on the question of unity consisted of a "stipulation of facts" which included not only statements of evidentiary fact, but also several exhibits including agreements under which CCA provided services to its foreign subsidiaries, annual reports, a speech, lists of employees, officers and directors serving both CCA and its subsidiaries, portions of tax returns and financial information. This stipulated evidence was in some respects ambiguous, incomplete and subject to contradictory meanings and inferences. Under the foregoing and hereinafter cited authorities, all ambiguitities and inadequacies in the evidence and inferences must be resolved in favor of the appellee taxing authority (FTB).

In its Statement of the Case (AB, p. 2-8) CCA makes no reference to any facts presented before the lower courts on the commerce clause or distortion questions raised below.[15/] This Court's Rule 34.1(g) requires the Statement of the Case contain all that is material to consideration of the questions presented. Accordingly, material omitted from the Statement of the Case may not be asserted by appellant as a basis for reversal, and this Court should refuse to consider any facts urged in support of contentions of distortion in the formula or commerce clause violations.

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15. This evidence consisted mainly of oral testimony of John C.McDonald, (J.A. pp. 118-223), stipulations as to what others would testify. (J.A. pp. 83-117).

A. The Unitary Question Should be Considered On The Basis of the Facts Contained in the Court of Appeal Opinion

This Court does not ordinarily look behind the facts stated in the final state court determination even when a constitutional issue is being reviewed. (See Time, Inc. v. Firestone (1976) 424 U.S. 448, 463; cf. California Liquor Dealers v. Midcal Aluminum (1980) 445 U.S. 111-112.) This Court should not do so here for at least two reasons.

First, as a matter of policy, because of the burden of reviewing the complete evidentiary detail in each case.[16/]

. . .

16. Cases coming through the appellate system (e.g., Firestone v. Franchise Tax Board (CA2 No. 62918) contain records with weeks of testimony and hundreds of multi-paged exhibits. The time consumed by a proper review by the nine judges of this Court of such a record, to determine whether each foreign activity is part of a unitary business, would cripple this

Second, this appeal from the final determination of the Supreme Court of the State of California, must be based on the same facts on which the California Supreme Court based its denial of CCA's Petition for Hearing. Under California Rule of Court No. 29, that decision was based upon the unitary facts set forth in the opinion of the California Court of Appeal. Rule 29, paragraph (b), California Rule of Court provides in part:

> "On petition for hearing the Supreme Court will not examine the record for error unless the petition shows that substantial issues of . . . fact were incorrectly stated . . . in the opinion of the Court of Appeal and that such issues were raised in the briefs and set forth in a petition for

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Fn. 16 (cont'd)
Court's ability to consider other important cases. Furthermore, a decision that the taxpayer was unitary or not unitary during a particular period would have no precedential effect since the operations of businesses vary from year to year.

rehearing in the Court of Appeal."17/ Appellant may not raise issues before this Court which it did not raise before the California Supreme Court. Thus, it is bound here by the same facts on which it presented its petition to the California Supreme, i.e., those set forth in the decision of the California Court of Appeal.

B. If the Record is Reviewed for Evidence of Lack of Unity, All Inadequacies, Ambiguities and Inferences Must Be Resolved Against the Taxpayer-Appellant and All Presumption in Favor of Unity Applied

On appeal the judgment of the lower court is presumed correct. All intendments and presumptions are indulged in favor of the judgment, and error must

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17. While CCA complains to this Court that the Court of Appeal opinion slightly misstated facts in three respects (AB, fn. 1 pp. 2-3), it did not point these alleged errors out on a Petition for Rehearing, and is therefore precluded from asserting them on further appeal.

be affirmatively shown. (Denham v. Superior Court (1970) 2 Cal.3d 557, 564.) The appellate court must accept as true all evidence supporting the findings as well as all inferences which might reasonably have been thought by the trial court to lead to the same conclusion. (Board of Education v. Jack M. (1977) 19 Cal.3d 691, 697.) Where opposing inferences may be reasonably drawn from the facts the trial court's judgment will not be set aside. (McIntyre v. Doe and Roe (1954) 125 Cal.App.2d 285, 287; Mae See v. North American Acc. Ins. Co. (1923) 190 Cal. 421, 426 (even where all the facts are admitted or uncontradicted.))

While California Appellate courts will accept as correct these facts which are stipulated by the parties to be true, where such facts are evidentiary facts and are themselves ambiguous or conflict with other facts stipulated to

be true, all inferences and resolutions of ambiguity must be against the party who has the burden of proof (CCA), especially where (as here) the trial court also made factual determinations against that party. Here where a taxpayer has the burden of establishing its burden by "clear, cogent evidence" (see ElDorado Oil Works, supra, at p. 744; Northfolk and Western RY Co., supra, at p. 688), the need to sustain the validity of California's tax on CCA as a unitary business where that determination is supported by any substantial evidence is even more clear.[18/]

It is believed that this Court has adopted and should continue to apply

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18. One strong policy reason for this rule is that taxpayers uniquely possess and control the records showing their business activities and the witnesses with personal knowledge thereof. Taxpayers are in a position to produce or

the approach that where an imposition of tax by a state is supported by substantial evidence that determination will not be upset. (See General Motors Corp. v. Washington (1964) 377 U.S. 436, 441-442 hg. den. 379 U.S. 875; Norton Co. v. Dept. of Revenue of State of Ill. (1951) 340 U.S. 534, 537-538.)

CCA argues that the tax asserted by California violates the Due Process and Commerce Clauses. In reviewing these arguments the Court's own caveat should be kept in mind:

> "The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor precision of

Fn. 18 (cont'd)

withhold this evidence at will. Placing any substantial burden upon taxing agencies to discover, obtain and produce admissible evidence from the taxpayer's records and employees would make administration of tax laws as applied to multi-national businesses substantially unenforceable whether determining the existence of unity or of arms length dealing under the federal approach.

> technical phrasing in their exercise of the most basic power of government, that of taxation. For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." (Wisconsin, v. J.C. Penney Co (1940) 311 U.S. 435, 444.)

The judgment should be affirmed unless CCA can show clearly and convincingly, based on the facts properly before this Court, that it has overpaid its tax (in a specific amount) because of a substantial infringement on a constitutional right. CCA cannot do so. The facts properly before this Court show that CCA's foreign subsidiaries are part of its unitary enterprise; CCA has not shown by its separate accounting, return-on-investment

or other arguments that California has charged an amount of tax grossly disproportionate to the amount of CCA's income producing activity in California; nor has CCA established any overpayment based on the Commerce Clause.

* * * * *

II

CCA'S FOREIGN SUBSIDIARIES ARE PART OF ITS UNITARY BUSINESS UNDER TESTS APPLIED BY THIS COURT

California's long applied test[19] of a unitary business has been stated by Frank Keesling, "father of the unitary concept":

> "The essential test is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state. If there is such a relationship, the business is unitary. If there is no such relationship, then the business in the state may be considered separate and the income therefrom may be determined without reference to the success or failure of the taxpayer's activities in other states."
> (G. Altman and F. Keesling, Allocation if Income in State Taxation, Commerce Clearing House,

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19. California courts also frequently examine "unities" of "ownership" "operation" and "use" ever since Butler Bros. v. McColgan (1941) 17 Cal.2d 664, 111 Pac.2d 334, affd. (1942) 315 U.S. 501, as was done in this case.

Inc., 2d ed 1950, p. 101.)
(Also see Edison California Stores v. McColgan (1947) 30 Cal.2d 472.) This test was also used by the Wisconsin Supreme Court in Exxon Corp. v. Wisconsin Dept. of Revenue, (1980) 90 Wis.2d 700, affd. 447 U.S. 207.)

The unitary concept as implemented by California consists of two parts -- formula apportionment and the combined report. All states use formula apportionment and some variant of property, payroll and sales to reflect corporate activities. The combined report was first utilized in the Edison California Stores, supra, case, and its basic purpose is to prevent the use of separate corporate entities to influence tax results. It is used by a majority of the states imposing a corporate income tax or franchise tax measured by income. Attached as Appendix D to this

brief is an amicus brief filed in the Illinois Supreme Court in the case of Caterpillar Tractor Co. v. Illinois Department of Revenue, which succinctly explains the operation and rationale of the combined report.

California law as construed by the California courts, mandates formula accounting and the combined report for all taxpayers operating a unitary business within and without California unless it is shown that the out-of-state business is truly separate and distinct from the California business. If the in-state business is dependent upon or contributes to the out-of-state business in any material respect, the businesses cannot be said to be truly separate and distinct. (Honolulu Oil Co. v. Franchise Tax Board (1963) 60 Cal.2d 417; Superior Oil Co. v. Franchise Tax Board, (1963) 60 Cal.2d 406, 386.)

This application of the unitary concept is consistent with its purpose. The existence of such contributions and dependencies evidences a flow of benefits which are not normally reflected in a separate accounting approach. Moreover, the benefits thus transferred are often not susceptible of pecuniary valuation. Indeed, a flow of benefits which defy monetary measurement makes all the more imperative the application of formula apportionment. Only by combining the income of in-state and out-of-state operations can this flow of benefits be properly accounted for. (Harley Treatise, Appen. E hereto.)

A. The Due Process Requirements of Unity Should be No Greater Than California's Contribution Test

This Court has stated that "the linchpin of apportionability in the field of state income taxation is the unitary-

business principle." (Mobil Oil Corp. v. Commissioner of Taxes (1980) 445 U.S. 425.) A taxpayer objecting to formula apportionment must show that the income "was earned in the course of activities unrelated to its activities in the taxing state" and arise from operations that are "distinct" in a business and economic sense which constitutes a "discrete business enterprise." (Ibid.) It would appear that this Court's language in Mobil means the same as California's "contribution" test. Where one part of a business contributes to another part, no "distinct" business exists.

B. Woolworth and ASARCO Reinforce the Rule That an Activity is Part of a Unitary Business Unless it is a Distinct and Discrete Business Which Does Not Benefit the Whole

On June 29, 1982, F. W. Woolworth v. Taxation and Revenue Dept. of New Mexico

50 U.S.L.Week 4957, ___ U.S. ___ (hereinafter "Woolworth"); and ASARCO, Inc. v. Idaho State Tax Commission, 50 U.S.L.Week 4962 ___ U.S. ___ (hereinafter "ASARCO"), were decided by this Court. These decisions dealt with the limited question of the right of a nondomiciliary state to include dividends received from related corporations in the income base subject to apportionment. This issue is not present in CCA; therefore, these decisions are not directly applicable or controlling.[20/] However, this Court chose

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20. Here the property, payroll and sales of the subsidiaries are considered to reduce share of unitary income apportioned to California. Idaho and New Mexico did not include the subsidiaries' property, payroll or sales in their formula, (see dissent in Mobil, 445 U.S. at p. 461-462) and did not apportion the subsidiaries' income, but apportioned only dividends received from subsidiaries which (some suggest) Idaho conceded were not part of ASARCO's unitary business. (Note that Idaho combined [California style] six subsidiaries without any disagreement. See Fn. 8, Opin.) It appears that Idaho and New Mexico thought that the questions

to discuss unity, and finding the subsidiaries to be engaged in entirely separate, discrete, and distinct businesses, refused to permit apportionment of their dividends.

In ASARCO this Court stated:

> "The Mobil Court explicated the limiting 'unitary business' principle by observing that geographic accounting, in purporting to isolate income received in various States, 'may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.' (Ibid.) The fact that 'these factors of profitability arise from the operation of the business as a whole,' ibid, therefore could justify a State's otherwise impermissible inclusion of corporate income derived from corporate activities beyond the State's borders."
> (ASARCO, Inc., supra, Opin. at p. 9.)

Fn. 20 (cont'd)

in ASARCO and Woolworth were different from whether the subsidiaries whose dividends they apportioned were part of the taxpayer's unitary business.

In Woolworth the court reiterated that it considers the unitary business principle as the "linchpin of apportionability." Then it observed

> " . . . that the potential to operate a company as part of a unitary business is not dispositive when, looking at 'the "underlying economic realities of a unitary business,"' the dividend income from the subsidiardies [sic] in fact is "derived[d] from "unrelated business activity" which constitutes a "discrete business enterprise."' Exxon, 447 U.S. at 223-224, quoting Mobil, 445 U.S., at 441, 442, 439.
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> " . . . . . .
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> "As relevant here, 'the income attributed to [a] State for tax purposes must be rationally related to "values connected with the taxing State." Norfolk & Western R. Co. v. State Tax Comm'n, 390 U.S. 317, 325.' Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978). The state court's reasoning would trivialize this due process limitation by holding it satisfied if the income in question 'adds to the riches of the corporation . . .'
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> " . . . . . .

> "In Mobil we emphasized, as relevant to the right of a State to tax dividends from foreign subsidiaries, the question whether 'contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale.' 445 U.S. at 438. If such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State. Ibid."
> (F. W. Woolworth Co, supra, Opin. at pp. 7 - 9.)

Thus, a taxpayer who seeks profitability from the business as a whole is operating a unitary business.

The court then observed that "no phase of any subsidiary's business was integrated with the parent's" that there was no centralized training, lending, purchasing, accounting control, etc. and concluded that there was "no functional integration." (Woolworth, supra, at p. 10-11.)

The court also found absence of

centralized management or economies of scale, stating "each subsidiary operated as a distinct business enterprise" without officers who overlapped or came from the parent, without personnel training or exchange to pass Woolworth information to the subsidiaries' operations, no parental participation in selecting store locations, no department overseeing the subsidiaries' operations (Woolworth, supra, at p. 11-13); the court found "no flow of international business." (Id., at p. 16.) The court concluded that the "business activities of the dividend payor had nothing to do with the activities of the recipient." Each of the subsidiaries operated a "discrete business enterprise" with a "notable absence of any umbrella of centralized management and controlled interaction" (Id., at p. 17.), and therefore the dividends were unconnected with the unitary business.

By analyzing Woolworth's activities in terms of "functional integration, centralized management and economies of scale," this Court determined that Woolworth's subsidiaries were separate, discrete businesses. Each was operated by its own management for its own advantage, not for the benefit of the whole. The facts reviewed by this Court suggest no contributions between Woolworth and its subsidiaries for the benefit of the whole, nor contributions to the other which were not accurately reflected under separate accounting.

We submit that the test of unity remains unchanged by Woolworth and ASARCO. Parts of a business which contribute to each other or to the profitability of the whole are unitary; while that activity which is a separate "discrete" business independently operated only for its own benefit and whose dealings (if any exist)

with other commonly owned businesses are handled in an arm's length manner the fair market value of which is accurately reflected in separate accounting records is non-unitary.

C. CCA's Subsidiaries Are Not Discrete Businesses. They Are Part of Its Unitary Enterprise.

Here CCA's foreign subsidiaries (and their incomes) benefit substantially from CCA's contributions of personnel, expertise (both technical and managerial), financing, supplying machinery, equipment and raw materials which are neither accurately nor adequately reflected by CCA's separate accounting. These reflect integration of function, economies of scale, centralization of management and overall operation and internal contributions for the good of the whole. The subsidiaries are part of CCA's unitary business. Formula apportionment is proper.

. . .

(1) Site selection and expansion of markets was centrally controlled.

> "CCA's Management Committee and Board of Directors reviewed and granted approval or disapproval to all suggestions for increased involvement in a present market, acquisition of an unrelated existing concern, or development of a neighboring market for the foreign subsidiary. Initial studies are made by the staff of the relevant subsidiary or CCA's Control Staff, as appropriate. In all cases, review was made by CCA's Senior Vice President for Overseas Operations and possibly other members of corporate staff prior to referral to the Board of Directors. If a subsidiary does not wish to proceed on a project, CCA must decide if it wishes to proceed independently." (J.A. pp. 16-17, ¶ 28.)

(2) International accounting was integrated.

> "CCA's involvement in the development of the subsidiaries' accounting procedures was primarily limited to developing formats for the transfer of necessary information to the United States. CCA needed financial information from the subsidiaries for two reasons: 1) to monitor the performance

of the subsidiaries; and 2) to file the reports mandated by the United States government." (J.A. p. 71, ¶ 136.)

"CCA worked toward achieving the most efficient systems and procedures possible." (J.A. p. 72, ¶ 139.)

(3) CCA centralized and integrated financial planning.

"Monthly financial statements (balance sheet and profit and loss statement) were furnished to CCA. Profits were reported by subsidiary on a monthly basis. In some cases local plant financial reports were furnished to CCA . . . . At the year end more detailed financial statements were furnished to CCA." (J.A. p. 71, ¶ 135.)

"Long range budgeting consisted of a three-year forecast each year of capital projects supported by forecast balance sheets and cash flow statements. The budgets were submitted to CCA. . . . These were usually reviewed by CCA in connection with its annual meeting. Capital projects for each year were reviewed by CCA in connection with its annual meeting. Capital projects for each year were reviewed on a quarterly basis by the Container Management Committee and Board of Directors." (J.A. p. 70, ¶ 134.)

> "If CCA could not determine a subsidiary's condition by merely reviewing its financial statements, it would have been forced to take a more active role." (J.A. p. 71, ¶ 136.)

(4) Auditing was centralized.

> "During the period all international subsidiaries except Holland and Germany were audited by Arthur Andersen & Company as was CCA." (J.A. p. 72, ¶ 138.)

(5) International legal matters were centralized.

> "None of the international subsidiaries used the same legal firms as CCA." (J.A. p. 72, ¶ 138.)

However, the Senior Vice President of Overseas Operations was also CCA's General Counsel. He and another attorney on CCA's "foreign operations staff" each devoted a portion of his time to handling CCA's international legal affairs. (J.A. p. 65, ¶ 126-127.)

(6) Purchasing material was integrated in part.

CCA made sales of linerboard and other paperboard of raw material requirements in small amounts. (J.A. p. 73, ¶ 141; J.A.:Ex. p. 8.) In addition, CCA made purchases of paper for the foreign subsidiaries.[21/] Even small amounts of material purchases from and through CCA in the United States must have been important because the materials are bulky and transportation costs high. (J.A. p. 73, ¶ 142.)

(7) CCA integrated and centralized machinery and equipment acquisition.

CCA sold used equipment to its subsidiaries at depreciated book value. (J.A. p. 76-77, ¶ 147.) It also purchased 90% of the equipment of its Latin American

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21. The purchases for the years before the court are unknown, but averaged in excess of $5,000,000 a year in the next subsequent three years. (JA.p. 74,¶ 143.) This figure, compared to the total Cost of Goods Sold for the foreign subsidiaries, estimated from Exhibits A, 1-8 (J.A.:Ex p. 8) to be no more than $80 million, suggests that CCA purchased six percent or more of the foreign operations Cost of Goods Sold. (See fn. 13 on evaluation of percentages.)

subsidiaries and 10% of the European subsidiaries' equipment. (J.A. p. 77, ¶ 148.)

(8) CCA provided a centralized source of key personnel.

CCA formed most of its subsidiaries and initially provided the personnel to train local laborers as well as manage the business operations. (J.A. pp. 14-15,¶ 25; pp. 41-42,¶ 78.) After the foreign operations had become established, CCA continued to provide personnel (normally key, skilled positions which could not be filled locally. Examples are described supra, pages 19 - 22. (See also Exh. D.)

In providing personnel, CCA would first look within its own organization. (J.A. p. 62, ¶ 120.)

(9) Centralized personnel training at CCA was provided.

Ten to twelve visits a year were made by groups of one to three foreign

employees to CCA for training. These visits lasted two to six weeks. Some were by plant managers. (J.A. p. 69, ¶ 132.)

(10) Key employees and managers were integrated into, and in substance remained employees of, CCA.

Thirty-eight high level American employees of the foreign subsidiaries were carried on CCA's payroll.[22/] They retained most CCA employee benefits; several even received stock options. (See p. 20, supra.)

(11) Centralized financing was provided by CCA.

CCA made substantial direct loans to its foreign subsidiaries, and guaranteed approximately one-third of their borrowings

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22. The total annual cost averaged $380,000, or approximately 2.5 percent of the total foreign payroll. (J.A. p. 60, ¶ 119.) Fifteen of the individuals had plant responsibilities, thirteen had unspecified (but presumably, plant) responsibilities. The total dispersion was eight to Mexico, five to Colombia, nine to Venezuela, four to Germany, and two to Italy. (Exh. C.)

from third parties. (J.A. p. 69-70, ¶ 122.) Thus, in addition to providing equity capital to the subsidiaries, CCA loaned directly or secured by guarantee, over one-half of all amounts borrowed by the subsidiaries.

(12) The paperboard/packaging function was integrated under CCA's control.

CCA and its subsidiaries all engaged in the paperboard/packaging business which consisted primarily of manufacturing paperboard from raw materials (wood pulp, straw, old paper), then manufacturing containers from the paperboard. CCA contracted by Technical Services Agreements to, and did, provide all technical, management and other assistance needed by the subsidiaries to function in that business, (see pp. 12-17 supra; J.A.:Ex pp. 10, 15, 21) and required its approval of any capital expenditure by each subsidiary.

(13) Centralized product design expertise provided economies of scale.

While packaging is normally designed for an individual product, CCA maintained a large design and market research laboratory in the United States (J.A. p. 27, ¶ 56), whose expertise was available to, and used by, subsidiaries. (J.A.:Ex pp. 9-33; J.A. p. 54, ¶ 104.) A central design laboratory in Europe serviced all European operations. (J.A. p. 34, ¶ 66.)

(14) CCA provided sales assistance.

CCA has referred United States customers to its foreign subsidiaries; and in at least one instance, helped negotiate an important contract for a significant new product (J.A. pp. 32-33, 47, ¶¶ 65, 87), even though packaging is not sold to the public and marketing by subsidiaries is apparently a minor function. (See pp. 29-30, supra.)

(15) CCA centrally managed its overseas operations just like it centrally managed its United States operations.

As is pointed out by the California court below (and pp. 6-7 supra), CCA operated its concededly unitary U.S.A. business in the same way it did its foreign subsidiaries--as a diversified business under substantially autonomous officers (regional vice presidents) who made the day-to-day operational decisions. When distances between business facilities become substantial, centralized operation of day-to day activities becomes difficult and inefficient. In both Butler Brothers and Exxon the operational departments were treated as independent profit centers. Yet this Court found each to be unitary businesses because of "benefits from an umbrella of centralized management and controlled interaction." (Exxon, supra, 447 U.S. at p. 224.)

Like an umbrella which is always available to help, but only used when it rains, centralized management and controlled interaction need not be "hands on" day-to-day control, but only a controlling higher management authority which knows what is generally going on and can be (and is when needed) used to see that the subsidiary operates for the good of the business enterprise as a whole.

While centralized control of day-to-day decisions may show that a business is unitary, it is not a prerequisite to "unity" for tax purposes. Centralized decisions by upper management to benefit the business as a whole suggest a unitary enterprise.

Substantial evidence of this unitary management goal of benefiting CCA's worldwide operations as a whole is present.

a) CCA publically holds itself out as a single integrated worldwide business. (See Exh. H, pp. 5-6 - Speech by CCA President; Exh. I - Annual Reports.)

b) A number of directors and officers serve both CCA and one or more subsidiaries at the same time. (Exh. E.)

c) CCA's Overseas Department centralizes the management of the foreign subsidiary operations. CCA has a foreign operations staff which includes three vice presidents, an attorney and a controller. (J.A. p. 65, ¶ 126.) One vice president for Latin America, and another of European operations spend full time in Latin America and Europe respectively. The Senior Vice President, stationed in U.S.A., travels to each subsidiary once or twice a year. His function is to "oversee CCA's foreign subsidiaries and communicate requirements for compliance with CCA's standards for

professionalism, profitability and ethical practices. (J.A. p. 66, ¶ 127.) Through the Overseas Department, current and three-year projected budgets and proposals for expansions and capital purchases by the subsidiaries are presented to CCA management.

(16) A centralized insurance agent is used.

Since 1967, CCA and all its subsidiaries use the same insurance agent. Earlier this centralization had not been extended to Europe. (J.A. p. 78, ¶ 149.)

The importance of centralized management, functional integration and economies of scale are as evidence of a "unitary" business' goal to work together toward maximizing <u>overall</u> profits, rather than each subsidiary being operated to maximize <u>its own</u> profits regardless of the effect on other CCA departments and subsidiaries.

In Exxon this Court referred to a centralized purchasing department "whose obvious purpose was to increase over-all corporate profits." (Id., at p. 224.) Further evidence of CCA's unitary operation is the fact that within each foreign country, several CCA subsidiaries operate as "an integrated unit" and not in competition with each other. (J.A. p. 31, ¶ 63.)

The fact that CCA did not require payment of fair market value for goods and services passing between it and its subsidiaries, (see pp. 32-35, supra) is not only further evidence of its intention that its business be operated as a unitary enterprise for the good of the whole, but also establishes the inaccuracy and inadequacy of its separate accounting as a method of apportioning income for tax purposes.

CCA has conceded that the fair value of some of the services it provides

to its subsidiaries cannot be determined. (J.A. p. 75, ¶ 144.) The sole use of the unitary concept is to support use of formula apportionment rather than separate accounting to apportion net income for tax purposes. Therefore, the inability to to segregate expenses by separate accounting should be considered strong support for use of formula apportionment.

California law creates a presumption that all operations under the same control in the same line of business are unitary. (See J.S. pp. A-16, A-17.) California places the burden of proof on the taxpayer to show its activities are not unitary. Both rules are proper and applicable here. In addition, the record clearly shows that the subsidiaries are not separate, "discrete" businesses each operated for its own separate goals. The Court of Appeal's determination that CCA's

foreign subsidiaries are each part of CCA's unitary enterprise should be affirmed.

D. Intercompany Product Flow Is not a Prerequisite to The Existence of a Unitary Business.

CCA argues that a large flow of goods is a prerequisite to a unitary business.

In the earliest cases considered by this Court, Underwood Typewriter Co. v. Chamberlain (1920) 254 U.S. 113 and Bass, Ratcliff & Gretton Ltd v. Tax Comm. (1924) 266 U.S. 271 there was manufacturing in one state with sales in another. Product flow existed in that one arm of the business manufactured a product and transferred it to another arm located in another state for sale. Appellant argues that this product flow is a prerequisite to a finding of unity. (AB pp. 40-49.)

Appellant's argument ignores subsequent decisions of this Court such

as Butler, Bros., supra. In that case there was central purchasing but no actual product flow. The court stated, " the operation of the central buying division along demonstrates that functionally the various branches are closely integrated." (315 U.S. at p. 508.)

As pointed out in the discussion in this Court's recent decision in Exxon Corp. v. Wisconsin, supra, centralized purchasing (or inter-company product flow) is only one indicia of a "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." What the court's decisions say is that if this tie exists, no further inquiries are necessary. It does not say as CCA claims that if the tie does not exist, then a business can not be unitary.

Appellant doubtless would argue that Butler Bros. did involve product flow,

but then what of Exxon? In that case the court found that, "[e]ven the gasoline sold in Wisconsin was available only because of an exchange agreement with another company . . . ." (447 U.S. at p. 224.) None of Exxon's production was utilized to produce the gasoline sold in Wisconsin.

Treating CCA's foreign operations as a separate and discrete business would fail to reflect the contribution made to any by them to the overall business "through functional integration, centralization ization of management, and economies of scale. (Mobil Oil Corp., supra,445 U.S. at p. 438.) Since such factors arise "from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation, it is not

constitutionally required." (Ibid.)

A state may

> " . . . take into account property situated elsewhere when it can be seen in some plain and fairly intelligible way that it adds to the value of the [property] and the rights exercised in the State.' This is directly applicable to to the carrying on of a unitary business of manufacture and sale partly within and partly without the State."
> (Bass, Ratcliff etc., supra, 266 U.S. at p. 232.)

The California Supreme Court clearly rejected product flow as a prerequisite of unity in Honolulu Oil Corp. v. Franchise Tax Bd., supra, 60 Cal.2d 417 and Superior Oil Co. v. Franchise Tax Board, supra, 60 Cal.2d 406. Many other examples of unitary business could be described where all parts contribute to the profit of the whole, and separate accounting cannot accurately apportion income, but there is no flow of goods.

While a state could choose (for facility of administration) to limit its use of formula apportionment to cases of large product flow, due process places no such limitation.

E. Income of Foreign Subsidiaries Which Are Part of a Unitary Business May Be Combined Without Violating Due Process

The argument that combined reporting denies due process when applied to unitary foreign subsidiaries of a domestic taxpayer has been rejected by this court in Mobil, supra, 445 U.S. 425.

> "The argument that the [foreign] source of the income precludes its taxability runs contrary to precedent. . . . Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.
>
> "The Court has applied the same rationale to businesses operating both here and abroad. Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924) is the leading example." (Id., at p. 438.)

> "Superficially, inter-corporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from these divisions would meet due process requirements for apportionability. Cf. General Motors Corp. v. Washington (1964) 377 U.S. 436. Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." (Mobil at pp. 440 441.)

Thus, it should be clear that California is not prevented from using formula apportionment merely because the unitary enterprise includes foreign subsidiaries. The sole remaining due process question then becomes whether the

formula "led to a grossly distorted result" by allowing taxation by California of an amount of income "out of all appropriate proportion to the business transacted" there. (Exxon, supra, 447 U.S. at p. 83.) Is the amount of income taxed by California "fairly related to the services provided by the state." (Id., at p. 84.)

* * * * *

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No. 81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, FOR THE FIRST APPELLATE DISTRICT

APPELLEE'S BRIEF ON THE MERITS

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Vol. II of II

III

CCA HAS NOT SHOWN DISTORTION BY THE FORMULA

CCA advances three arguments in support of its position that the use of the unitary business principle by California in this case results in substantial misattribution of income in violation of the Due Process Clause. First, it argues that formula apportionment attributes significantly more income to California than was determined for federal income tax purposes by applying the "sophisticated" accounting techniques prescribed by the Internal Revenue Service. Second, it argues that there are significant differences in wage rates between the United States and foreign countries resulting in misapportionment of income. Finally, it argues that profitability of foreign operations, expected and actual, is higher and this fact is not reflected

in the formula.

CCA's failure to set out any facts pertaining to these arguments in its Statement of the Case should cause peremptory rejection of these arguments. Additionally, examination of each of the arguments and the evidence submitted in support of them demonstrates that CCA has not established that any misattribution of income occurs.

A. Separate Accounting Data Does Not Impeach the Formula

The use of separate accounting data to impeach formula results was recently rejected by the court in Exxon.

> "As this court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes. For example, in Butler Bros. v. McColgan, supra, an interstate business challenged the application of the California apportionment statute. The company was engaged in the wholesale dry goods and general merchandise business as a middleman,and it had distributing

houses in seven States, including one in California. Each house maintained stocks of goods, had a cognizable territory, had its own sales force, did its own solicitation of sales, made its own credit and collection arrangements, and kept its own books. There was, however, a central buying division that was able to purchase goods for resale at a lower price. The company used 'recognized accounting principles,' [citation] to allocate all costs and charges to each house, with certain centralized expenses allocated among the houses. Based on that 'separate accounting system,' [citation] the business asserted there was no net income in California.

"We concluded that California could constitutionally apply its apportionment formula to the company's total net income to establish taxable income, rather than being limited to the income shown by the taxpayer's accounting methods to be attributable to the one house in that State. The company had the 'distinct burden of showing by "clear and cogent evidence" that it results in extraterritorial values being taxed,'[quoting Norfolk and Western R. Co. v. North Carolina 297 U.S. 682] and the taxpayer's accounting evidence was insufficient to meet that burden.

"'[W]e need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extra-territorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders . . . . That may be due to the fact, as stated by Mr. Justice Brandeis in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, that a State in attempting to place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Furthermore, the particular system used may not reveal the facts basic to the State's determination. [Citation.] In either aspect of the matter, the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here.'"
(Exxon Corp. v. Wisconsin, supra, 447 U.S. 207, 221-222.)

Evidence of the merit of the Court's analysis exists both in a general

context and in the specifics of this case. The General Accounting Office (GAO) has recently released a study of the Internal Revenue Service's administration of the arm's-length standard and found:

> "Multinational corporations have both the incentive and the opportunity to shift income between jurisdictions to take advantage of disparate corporate tax rates. One incentive is minimization of taxes. The opportunity lies in the pricing of interorganizational transactions. Obviously, possession of incentive and opportunity does not axiomatically lead to abuse--but to tax administrators, American and foreign, it represents a vulnerability to guard against.
>
> "IRS, however, has not yet developed baseline information on the incidence and magnitude of multinational corporation noncompliance in terms of improper shifting of income. Thus, IRS has no sound basis for determining the amount of audit resources to be assigned to address the problem, nor for gauging the success of those resources that are applied to it.
>
> "Further, IRS enforcement difficulties are compounded by

> the complexities involved in measuring the amount of income misallocated in those instances where this is believed to have occurred. Ideally, interorganizational pricing is to be adjusted to that for similar transactions between unrelated parties--the so-called 'arm's length standard.'
>
> "However, in the modern economic system of multinational corporate business, a true arm's length price can rarely be identified. When an arm's length price cannot be identified, Department of Treasury regulations for Internal Revenue Code Section 482 provide both the corporate taxpayer and the IRS examiner some guidance for arriving at a constructed price. The regulations and the resulting enforcement process, however,create an unacceptable level of uncertainty and a significant administrative burden both for corporate taxpayers and IRS examiners."
> (Report to the Chairman, House Committee on Ways and Means by the Comptroller General, Sept. 30, 1981, pp. 24, 53-54.)

In at least three cases, Bass, Butler Bros. and Exxon, this Court has sustained a state's attribution of income to activities in that state even though the company's separate accounting (federal

tax return) showed that it earned no net income in that state.

For a further comparison of the unitary method and the so-called "arm's length" standard and, specifically, the inadequacies of the arm's-length method, see "Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code," 89 Harvard Law Review 1202 (1976) and the Harley Treatise, appendix E hereto.

In the case at bar, the parties have stipulated to the accuracy of the data contained in a number of exhibits filed with the California courts. CCA argues that this separate accounting data should be controlling in determining the amount of its California income. Similar stipulations and arguments were specifically made in Butler Bros., supra, and in many other cases and have not been found controlling. Examination of the

documents and the stipulation in this case discloses why they are not.

CCA was not fully compensated for various services rendered to and benefits it conferred upon its foreign subsidiaries. Specifically, CCA stipulated that the value of many such services could not be ascertained; reimbursement received under some Technical Service Agreements was only to the extent allowed by the foreign governments; used equipment was sold at book, not fair market value; CCA brokeraged equipment at a fee less than would be charged by a third party; no fees were paid for loan guarantees; interest paid to CCA by its subsidiaries was apparently far below normal interest rates; other services were provided without being paid for. (See pp. 32-35, supra.) There were

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. . .

substantial amounts of Subpart F income.[23] (J.A.:Ex p. 7.)

In sum, CCA has not established that net income either shown in its separate accounting records or reported for U.S. income tax purposes accurately reflects the many contributions made by CCA to its subsidiaries, but on the contrary, substantial contributions by CCA are not reflected accurately or at all.

Further, even accepting CCA's separate accounting figures, the formula only apportions less than .01 more of the unitary worldwide net income to California over the .07 which CCA concedes that

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23. Subpart F income is determined under Internal Revenue Code, sections 951-964. In general it is income assigned by a corporate group to a controlled foreign corporation which is redetermined for federal purposes to be taxable to the parent company in the United States. Appellant, in its presentation on pages 16 and 17, has not included this income in its calculations of U.S. source income.

California may tax. (See pp. 36-37, supra.)

B. Differing Wage Rates and Rates of Return Do Not Impeach the Formula

The second and third arguments advanced by CCA in support of its misattribution of income arguments are dependent upon separate accounting data for their analysis. Such data has already been shown to be inaccurate and in any event, inappropriate for use in state tax on income of a unitary business. Furthermore, even assuming arguendo the separate results of the various entities provided valid data for comparative purposes, these arguments fail because the premise on which they are based is false and because CCA has not offered any supporting relevant data.

The premise on which these arguments is based is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized

in one state, typically produced roughly the same amount of income as a dollar so spent or sales made in other states. (J.S. p. 17.)

This premise is false, as both the California courts and this Court have recognized.

> "In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income . . . but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process." (John Deere Plow Co. of Moline v. Franchise Tax Board, 38 Cal.2d 214, app.dis. 343 U.S. 939.)

Formula apportionment does not assume that a dollar spent in Latin America

had the same value as a dollar spent in California, or that a dollar in wages has some relative productivity as a dollar of property. Property, labor and sales all contribute to the ultimate net income of a business. A state provides services to protect property and workers as well as sales, which would have some rational relationship to the quantities of property, labor and sales activity present in the taxing state. A unitary business may have none to a great deal of any of the three factors, depending on how and where a business operates.

In support of its wage differential argument, CCA submitted evidence to the California courts that the average hourly wages paid in various countries were less than those paid in the United States, both absolute and when adjusted for productivity. But the data submitted and studies referred to involve a variety of

years, none of which is involved in this appeal.

Where machinery is automated, the number of workers (and wages) will be reduced substantially, but a single machine operator will probably be more highly paid and (together with his machine) will produce more. A research facility with many expensive scientists will raise the wage factor substantially wherever it is located; but it will produce no sales there. The three factors are interdependent and cannot be analyzed separately. Nothing is proven by simply comparing wage rates in one place to those in another.[24/]

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24. The wage figures which CCA tries to use are in part just general statistics by countries which have not been shown to apply to CCA. CCA's own figures are for different years from those in issue. FTB disputes the correctness and applicability here of such figures and the testimony on which they are based. Since the California courts ruled against CCA they may not be treated as correct on appeal.

As this Court stated in Norfolk & W. R. Co. v. North Carolina, supra, 297 U.S. 682, in the context of a different apportionment formula, but the same logical consideration:

> "The implications of the formula being what they are, a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. Its evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal." (Id. at p. 688, emphasis added.)

The third argument advanced by CCA in support of its misattribution theory is that the expected and actual rate of return on foreign investments is higher than the return on United States investments.

The use of the return-on-investment analysis for foreign subsidiaries was subject to criticism in a Harvard Business Review article by Sidney M. Robbins and Robert B. Stobaugh entitled "The Bent Measuring Stick for Foreign Subsidiaries."

(Sept-Oct 1973, p. 80.) The article was directed to the problem of evaluating management performance, but is equally applicable to the present setting.

> "[T]heir underlying assumption typically is that a subsidiary can can be reviewed by using a companywide return-on-investment (ROI) criterion, with only a few necessary adjustments. Such an approach not only neglects significant aspects of subsidiary operations but also fails to consider the reasons for which the subsidiary was originally founded.25/

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25. "The use of an enterprisewide criterion such as return on investment as a yardstick against which to measure performance implies that the financial statements of a subsidiary reflect its performance. However, to do so accurately, these statements must be adjusted to take into account the extent to which the subsidiary influences the profits of the other units in the system. Yet any enterprise attempting to make such adjustments encounters acute complexities."("The Bent Measuring Stick . . .", supra, at p. 83.) Fn. cont'd

The investment return analysis

ignores the substantial contributions by the
the parent of a unitary business to the

Fn. 25 cont'd

Such adjustments have not been made by CCA and probably could not be made.

Companies make investments in foreign operations for long-range strategic considerations,

> [H]owever, they tend to forget this fact when subsequently evaluating their foreign subsidiaries' performance. The system in all its inter-relationships is liable to be hidden under an account book when the moment arrives to add up the score and judge the performance of individual foreign units . . . ."
> (Rent Measuring Stick . . ., supra, at p. .)

Items which can affect the analysis are:

> ". . . a parent's guarantee of a loan . . . ."
> (Id., at p. 81)

> "Then there are the intagible items, such as the strategic considerations discussed earlier, whose worth or cost is even more elusive; to date they have universally been omitted

foreign subsidiary's book profits which do not take into consideration the substantial costs of developing a business

Fn. 25 cont'd

> from the initial formal calculations. For example, no manager of a major oil company would want to risk being left out of a potentially giant oil field that one of his company's rivals is exploring, even if the calculations of expected costs and returns might show a loss when discounted cash flow procedures are used. The risk of a rival finding a huge, low-cost oil field, and thereby gaining a superior long-run competitive position, is too big for the manager to take. Likewise, in manufacturing, there is a long-run risk that a rival will expand more rapidly and thereby achieve greater economies of scale." (Id., at p. 81)
>
> "'In considering a new foreign investment, we take into account all profit over the marginal cost of all components shipped from our Michigan factory to the foreign plant. But later, when we report the profit or loss of the subsidiary, we use a standard intercompany price

and products which for small incremental costs can be produced very profitably (using separate account by a new subsidiary.26/

Fn. 25 cont'd

> that is based on average costs plus a profit.'" (Bent Measuring Stick . . ., supra, at p. 84.)

In the transfer and valuation of used equipment that had little value on the market,

> ". . . the incremental costs to a parent of providing services for a subsidiary usually are quite low; but the value to a subsidiary can be substantial." (Id., at p. 84.)

26. The San Diego Union (Aug. 14, 1982, p. C-9) reported that Oak Industries is shifting production of its most sophisticated product lines to Taiwan. Its spokesperson stated, "As long as we've been in Taiwan - 20 years or more - it has always been our practice to get production started here [in the U.S.], work out the bugs and then take a 99.9% perfected product to Taiwan."

CCA's evidence on ROI totally ignores the unitary nature of the business. It is disputed, was rejected by the California courts and should not be considered here.

CCA's arguments do not impeach the formula apportionment or establish that California has taxed more income of CCA's unitary business than is reasonably related to CCA's substantial business activity (property, employees and sales) in California.

IV

THE COMMERCE CLAUSE DOES NOT REQUIRE REVERSAL

CCA contends that (1) California's formula apportionment here results in taxation of income also taxed by foreign countries (AB pp. 21-27), and (2) prevents the federal government from speaking with one voice in foreign policy. (AB 27-36), both alleged in violation of the Commerce Caluse. Both concepts are taken from language in Japan Line Ltd. v. County of Los Angeles (1979) 441 U.S. 434 (hereinafter "Japan Line") FTB submits that the Japan Line rulings are inapplicable to this case and facts properly before this Court show neither double taxation nor interference with foreign policy.

A. Here No Tax is Imposed on Foreign Commerce

CCA is a Delaware corporation with its headquarters in Illinois. It

does business in California. In addition, CCA owns a number of subsidiaries which are incorporated in foreign countris and do business in foreign countries. California has assessed a tax against CCA, but it has neither asserted nor assessed a tax against any of CCA's foreign subsidiaries. Under the unitary business principle, California has included the property, payroll, sales and net income attributed by CCA to its foreign subsidiaries under CCA's separate accounting methods in the formula used to determine the amount of income properly attributable to California, because the subsidiaries are part of CCA's unitary business.

If CCA could establish that its foreign subsidiaries were not part of its unitary business, California would not require their inclusion in the combined

report. The apportionment method used was an effort by California to reach that income, and only that income, which was earned or properly attributable to activities within its borders. California, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the process conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in the record, reached, and was meant to reach, only the profits earned within the state. (Underwood Typewriter v. Chamberlain, supra, 254 U.S. 113; Hass, Ratcliff, etc., supra, 266 U.S. 271.)

CCA averaged over $10 million in California payroll, $15 million in property and almost $30 million in sales in California (J.A.Ex, pp. 2,4,6) in each

year in issue, for the government services to which California has requested about $200,000 per year in tax based on CCA's California income. This does not tax extraterritorial values. The tax totals only 6% of the California sales, a reasonable payment for the substantial services provided by the state by any standard.

This case taxes a domestic corporation doing substantial business here. It taxes no foreign business or instrumentality. Japan Line is totally foreign to the case at bench. In Japan Line the tax was directly on a container, an instrumentality which was moving in foreign commerce. It was owned by a Japanese Company. The property tax under discussion in Japan Line was directly on a foreign instrumentality moving in foreign commerce which "remain outside Japan only so long as needed to complete their international

missions." (Japan Line, supra 441 U.S. at p. 452.) The Japan Line decision stated,

> "The question here is a much more narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." 27/

Japan Line itself thus severely restricted its application to a situation not present here. In Mobil this Court reiterated the distinction which makes Japan Line inapplicable to income taxation of unitary businesses.

> "Appellant's attempted analogy between this case and Japan Line strikes us as forced. That case involved ad valorem property taxes assessed directly upon

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27. "Accordingly, we do not reach questions as to the taxability of foreign-owned instrumentalities engaged in interstate commerce or of domestically owned instrumentalities engaged in foreign commerce." (Japan Line, at p. 444.)

> instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." (Mobil, supra, 445 U.S. at p. 448.)

Japan Line itself said that multiple tax and impairment of federal uniformity are additional considerations, when a "state seeks to tax the instrumentalities of foreign commerce." (Japan Line at p. 446.) Here California is taxing no instrumentality of foreign commerce.

B. CCA Has Not Proven Unconstitutional Double Taxation Here

Japan Line distinguished income taxation of a unitary business by formula saying,

> "In Moorman, the problem arose, not from lack of apportionment, but from mathematical imprecision in the formulae. Yet, this Court consistently had held that the Commerce Clause 'does not call for mathematical exactness . . .; only if the resulting valuation is palpably excessive will it

> be set aside. [Citations.] This case, by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist . . . ." (Id., at p. 455.)

In contrast the division of the income of a unitary business among the several taxors is necessarily a task of apportionment, whether by formula, attempt to reconstruct a fictional arm's length separate accounting, acceptance of the taxpayers own separate accounting, or otherwise. The Japan Line discussions of double tax were not intended to apply here.

The Japan Line court discussed and approved its earlier Moorman decision which recognized that different methods of apportionment which could result in multiple taxation are permitted by the Commerce Clause. (441 U.S. at p. 455.) It noted, however, that Japan Line

> ". . .concerns foreign commerce. Even a slight overlapping of tax --

> a problem that might be deemed de minimis in a domestic context -- assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." (Id., at p. 456.)

As shown above, here California is merely taxing CCA, a domestic corporation. Unlike Japan Line, there are no "sensitive matters of foreign relations and national sovereignty" involved in determining the amount of income taxable by California to CCA.

In the field of income taxation (unlike property taxation) taxation of the same income at both state and federal levels is specifically permitted. "Concurrent federal and state taxation of income, of course, is a well established norm" (Mobil, supra, 445 U.S. at p. 448.) CCA has not attempted to show any state

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. . .

level income tax other than California's.[28]

Multiple taxation at a federal (country) level does not invalidate California's tax. In practice, the United States gives tax credits for taxes paid to foreign countries to mitigate (if not eliminate) such national level double taxation. Where U.S.A. has already given a credit for a foreign income tax, the result should be the same as if both California & U.S.A. had originally taxed the same income.

Where a credit has been given once (by U.S.A.) for a foreign income tax,

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28. California taxed about 8% of the unitary income. The foreign countries taxed less than one-third. (AB p. 17.) Less than half of CCA's unitary income has been taxed by California and the foreign countries (even using the evidence which has been rejected by the trial court and is not properly before this Court). CCA has not properly shown any actual double taxation or any reasonable risk of it, (except by both U.S.A. and California perhaps.)

allowing a second credit against California's would be totally unjustified.[29] No unconstitutional multiple tax results from allowing both a federal and state level tax on the same income.

Risk of double taxation of income is inevitable because there is, in fact, not uniformity of tax laws (let alone in their application.) Only if absolutely identical income tax laws were identically applied could double tax be certainly avoided. The record shows no such identical tax laws between any two countries (let

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29. Assume a taxpayer paid $5 foreign country tax and $20 U.S. tax (minus $5 credit), and $7 California tax, he would end up paying $5 foreign, $15 U.S. and $7 state level tax. If California were required to avoid double tax he would pay $5 foreign, $15 U.S. and only $2 state level. But if he paid no foreign tax he would pay $20 U.S., and $7 California taxes. A tax credit should be allowed only once, i.e., against federal income tax.

alone as to all of them.) Nor do we believe it can. In this writer's experience, income tax laws vary substantially from country to country both as to income taxed and deductions and credits allowed. CCA concedes that even the accounting methods (by which the income and deductions are calculated) vary from country to country. There is no such thing as a uniform "arm's length" method. Indeed, U.S.A. made no "arm's length" adjustments in CCA's income for payments (or lack thereof) by its subsidiaries which were not full value for services rendered by CCA. (J.A. pp. 78-79,¶ 151.) This shows both non-uniformity in application and inadequacy of the so-called arm's length method. The fact that this Court has no control over the methods of calculating tax used in foreign countries does not deprive the United States or any

state of the right to tax a fair share of the income of a multinational unitary enterprise.

CCA has proven no unconstitutional double taxation.

> "Appellant's reasoning tracks the rationale of Japan Line, that is, that separate accounting is required because apportionment necessarily entails some inaccuracy and duplication. This inaccuracy may be tolerable for businesses operating solely within the United States, it is said, because this Court has power to correct any gross overreaching. The same inaccuracy, however, becomes intolerable when it is added to the risk of duplicative taxation abroad, which this Court is powerless to control. Accordingly, the only means of alleviating the burden of overlapping taxes is to adopt an allocation rule. . . .
>
> ". . .[N]othing about the logic of Mobil's position is limited to dividend income. The same contention could be advanced about any income arguably earned from foreign commerce. If appellant's argument were accepted, state taxing commissions would face substantial difficulties in attempting to determine what income does

or does not have a foreign source."
(Mobil, supra, 447 U.S. at pp. 446-447.)

C. CCA Has Not Proven Interference in Violation of the Commerce Clause With Foreign Relations

As has been pointed out already, California is simply here taxing a domestic corporation. No foreign sovereign has any legitimate interest or concern with California's taxation of CCA. Nor do those in the federal government who handle foreign relations.

The Commerce Clause provides that "the Congress shall have the power . . . to regulate commerce with foreign Nations . . . ." (U.S. Const., art I, § 8, cl. 3.) The Congress has expressed its foreign policy on use by states of formula apportionment of income of multinational unitary businesses. It has rejected all attempts to limit its use.

Particularly, the Senate even rejected a clause in a treaty with Great Britain which would have stopped use of formula apportionment only where British corporations had no contact with U.S.A. except through a subsidiary, but would have continued to permit it here and in all other cases. (Reservation of Art. 9(4) of the U.K. Convention for Avoidance of Double Taxation.)

This Court has recognized that absent action by Congress, formula apportionment does not interfere with federal foreign policy.

> "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. [Citations.] Legislative proposals have provoked debate over issues closely related to

> the present controversy. See, e.g., New York State Bar Assn. Tax Section Committee on Interstate Taxation, Proposals for Improvement of Interstate Taxation Bills (H.R. 1538 and S. 317), 25 Tax Lawyer 433 (1971). Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so." (Mobil, supra, 445 U.S. at pp. 448-449.)

To the extent that the actions of the executive branch should be considered,[30] during the period in issue, formula apportionment was clearly considered proper. Subsequent policies should not affect this case. However, by notice dated December 20, 1979, the

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30. There is nothing on this properly before this Court.

Department of State stated to the Ambassador of the Netherlands that, "This Department is not in a position to conclude that [formula apportionment involving a Dutch company and U.S. subsidiaries is] inconsistent with either the standards set forth in the treaty or general principles of international law."

The Solicitor General has, in the pending Chicago Bridge & Iron (CBI) case No. 81-349, expressed concerns about situations involving foreign businesses headquartered abroad. He conceded in oral argument that formula apportionment of multi-national unitary business income "does not violate any provision of any particular treaty." (Apr. 19, 1982, RT p. 18.) Various attorneys for the federal government are too often diverse in their opinions. (See Sullivan v. United States (1969) 395 U.S. 169, 185 fn. 2.)

The Solicitor General does not dictate what is the policy of this country on foreign relations. The Executive Branch has specifically indicated its acceptance of the states' use of the unitary business principle in its negotiation of Conventions to Prevent Double Taxation and Friendship Commerce and Navigation Treaties. With respect to the Convention between the United States and the Soviet Union for the Avoidance of Double Taxation, the Treasury Department stated:

> "With respect to the Soviet Union, the taxes and dues covered by the Convention are defined in subparagraph (a) of paragraph 1 as those provided for by the All-union legislation of the Soviet Union. The term "All-Union legislation" is not meant to refer to a specific law or code but is a generic term covering legislation at the national level that applies throughout the Soviet Union. The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, in

> keeping with past U.S. policy the taxes of the state and local governments of the United States are excluded from the scope of the Convention, except for purposes of Article X (Non-discrimination).

Standard Friendship, Commerce and Navigation Treaties contain general language dealing with the subject of taxation, including language providing the contracting states "shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to territories "of the taxing authority]" on citizens of the foreign country. (FCN Treaty with the Netherlands, Art. XI ¶ 4.) Department of State annotations explaining the standard treaty language clearly shows that formula apportionment by states is anticipated and acceptable.[31/] We have

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31. A State Department study in 1980 explained the terms "reasonably allocable or apportionable" in footnotes.

fn. cont'd

found no restrictions on any country's power to tax its own citizens (including domestic corporations like CCA) in any way it chooses. Indeed, the Department of State

Fn. 31 cont'd.

> "This provision provides an elementary, although incomplete, safeguard against double taxation by stipulating that taxes shall be imposed on only that portion of a nonresident alien or alien corporation's income that is truly representative of the income or profits derived from operations within the taxing country. The intent is to prevent taxation of global income. It does not necessarily preclude taking into account the entire income, capital and property of an enterprise,' wherever situated, as, for example, in determining the rate of tax. It does seek to prevent the ascertainment or measurement of the tax base, to which such rate is to be applied, on the basis of what is outside the country.
>
> "Article XI (4) does not attempt to provide a set formula by which the allocation or apportionment shall be made. It takes into consideration the accounting complexities and

has argued that FCN Treaty provisions do not apply to companies incorporated in U.S.A. (See Sumitomo Shaji America, Inc. v. Avagliano (June 15, 1982) 50 U.S.L. Week 4643, 4645.) This Court also noted in

Fn. 31 cont'd/

> and problems of value judgment that are unavoidable, for example, in attempting to determine a reasonable allocation for a large multinational corporation. No single formula for this calculation has been agreed on. There are a variety of systems that meet the test of reasonableness as that test has come to be applied in United States jurisprudence. The various states have adopted a variety of tax bases which have received the sanction of the courts, including gross product, net sales, turnover, amount of property held in the State, and combinations of these various bases. The crucial element is that some test be applied and that it be 'reasonable.' The intent in employing that term by courts in this country. For the relationship of State actions in this field to the overall question of the States' treatment of 'foreign' and alien corporations, see Article XXII(4).

Sumitomo that the interpretations of similarly worded FCN Treaties may vary because of different negotiating histories. (Id., at p. 4646, fn. 12.) Thus, a thorough examination of all negotiations and treaties and other documents pertaining to the "one voice" assertions must preceed any conclusion that U.S.A. has adopted some so-called "arm's length" method as the exclusively permitted means of taxing income of businesses engaged in foreign commerce.

Fn. 31 cont'd

> "The term 'allocable' is considered as assigning or applying a share of total income on a percentage basis, which conceivably could be somewhat arbitrary and uneven in proportion.
>
> "The term 'apportionable' is considered as implying an equal division among the various elements involved. The two terms, taken in conjunction, are intended to cover all the various methods, proportionate or otherwise, by which a reasonable tax base might be determined."

With respect to both of the state taxes involved in Washington Rev. Dept. v. Stevedoring Assn. (1978) 435 U.S. 734 and Michelin Tire Corp v. W. L. Wages (1976) 423 U.S. 276, this Court stated:

> "It did not usurp the Federal Government's authority to regulate foreign relations since it did not fall on imports as such because of their place of origin. [Citation.] As a general tax applicable to all property in the State, it could not have been used to create special protective tariffs and could not have been applied selectively to encourage or discourage importation in a manner inconsistent with federal policy.
>
> " . . . . . .
>
> ". . .[T]he tax does not restrain the ability of the Federal Government to conduct foreign policy. As a general business tax that applies to virtually all businesses in the State, it has not created any special protective tariff. The assessments in this case are only upon business conducted entirely within Washington. No foreign business or vessel is taxed. Respondents, therefore,

> have demonstrated no impediment imposed by the tax upon the regulation of foreign trade by the United States." (Stevedoring, supra, at pp. 753, 754.)

Similarly here, CCA has not demonstrated any impediment on federal regulation of foreign trade or any Constitutional violation.

* * * * *

V

AMICI SUPPORTING APPELLANT SHOW NO UNCONSITUTIONALITY

Because of space limitation, response to much of Amici arguments is integrated into the preceeding responses to appellant's brief. Most factual matter referred to by Amici supporting appellant is not properly before this Court and should be ignored; however, even considering it, no unconstitutionality is shown.

Specific comment is made on briefs of Firestone, EMI and Shell Petroleum N.V. ("SPVN") because each has litigation now pending in California courts.

1. Firestone, like CCA, is simply an American-owned and based multi-national enterprise conducting a unitary business (producing rubber products and rubber) through subsidiaries. It makes basically the same arguments as CCA.

2. EMI is a U.K. corporation doing business in U.S.A. solely through a wholly-owned subsidiary, Capitol-EMI. California has included a unitary recording business in its formula when taxing Capitol-EMI. EMI's primary argument, that international law and custom prevents use of formula apportionment, is directly refuted by Congress' recent rejection of Article 9(4) of the U.K. Convention which would have created the insulation of British parent corporations from combination by states' with their unitary American subsidiaries.

3. It is asserted in the amicus curiae brief of Shell Petroleum N.V. that worldwide combination "can have particularly spectacular distorting effects" where the foreign company is the parent and the operations of a domestic subsidiary are relatively small in comparison with overseas operations.

(Brief A.C., Shell Petroleum, pp. 9-10.) SPNV cites by way of illustration the FTB's treatment of two of its subsidiaries, Scallop Nuclear, Inc. and Shell Oil Company, which has been challenged by SPNV in Shell Petroleum N.V. v. Mary Ann Graves, et al., No. C 81 4302 MPH (N.D.Cal.). On August 10, 1982, the District Court dismissed SPNV's action on the grounds that SPNV lacked standing to sue and that the controversy was not ripe for decision. An appeal to the Court of Appeals for the Ninth Circuit (Docket No. 82-4535) was filed by SPNV on September 3, 1982.

SPNV's illustration of the "spectacular distorting effects" of worldwide combination is itself a distortion of the facts in the Shell case. As of the present time, the FTB has not sought to tax Scallop Nuclear on $46,000,000 of apportioned income, as SPNV claims; in fact, the FTB has issued

no assessments at all against Scallop Nuclear. (See Complaint ¶32 (N.D. Cal. Nov. 4, 1981.) Proposed assessments for six of ten years under audit were issued against Shell Oil, but only after officials of that company not only refused to furnish information on Shell's operations relevant to the question of unity, but also refused to extend the statute of limitations applicable to a reassessment of taxes. (See Kashiwagi Aff. ¶¶ 13-15; Watson Aff. ¶4 (N.D. Cal. Apr 19, 1982.) Under the circumstances, the FTB auditor assigned to Shell Oil was forced to protect the revenue by issuing proposed assessments in which all doubts were resolved against the taxpayer. (Kashiwagi Aff., supra, at ¶ 15.) As a result of pending administrative proceedings, multimillion dollar adjustments already have been proposed. (Watson Aff., supra, at ¶ 7.)

In view of the above facts, the District Court held that the controversy in Shell was not ripe for adjudication because (1) no tax assessments have been issued against Scallop Nuclear, and (2) though proposed tax assessments for some of the years in question have been issued against Shell Oil, such assessments are still in the process of administrative review. In ruling on the question of standing, the District Court rejected the contention of SPNV that cited provisions of the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and the Netherlands (which provisions refer to "nationals and companies of the [Netherlands]" apply to the taxation of a U.S. subsidiary

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of a Netherlands parent.[32] The court stated:

> "It is clear that a company of the Netherlands which itself transacts business in the United States falls within the zone of interests sought to be protected by the Treaty; but it is also clear from Sumitomo Shoji that a U.S. corporation and its foreign parent are not mere extensions of each other, for Treaty purposes."
> (Memorandum Decision and Order, p. 10 (N.D. Cal. Aug. 5, 1982.)

The District Court concluded that neither the FCN treaty with the Netherlands nor the U.S.-Netherlands Double Taxation Convention of 1948, as amended, vests rights in Netherlands shareholders of a domestic corporation to redress an

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32. The Government of the Kingdom of the Netherlands has made the same contention both in the amicus curiae brief filed in this Court and in an amicus curiae brief filed in the Shell case. (See Memorandum of the Government of the Kingdom of the Netherlands as Amicus Curiae (N.D. Cal. April 19, 1982.)

alleged injury to the corporation.

CONCLUSION

Most of the factual matter relied on by appellant (and its Amici) is not properly before this Court and should not be considered. However, even considering such improper "evidence" no unconstitu - tionality, overpayment of tax or any ground for reversal has been shown.

The facts show substantial technical, managerial and financial services as well as capital assets and raw materials were furnished by CCA to its subsidiaries which are not adequately reflected in separate accounting figures. The foreign subsidiaries were part of CCA's unitary business. CCA's reliance on separate accounting approaches which ignore the integration and interdependence within a unitary business fails to show any distortion or extra territorial

taxation by formula apportionment. No due process violations are shown.

Nor have Commerce Clause violations been shown. CCA has proven no "double taxation" here; absence of international uniformity of accounting methods, tax laws and their application makes some double taxation of unitary multi-national enterprises inevitable; neither this nor taxing the same income at both state and national levels is constitutionally prohibited. Congress, the State Department and this Court have all approved international use of formula apportionment; it does not interfere with federal conduct of foreign

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relations; especially here where the taxpayer is a domestically incorporated and owned taxpayer.

The judgment should be affirmed.

Respectfully submitted,

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Attorney General

NEAL J. GOBAR,
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Attorneys for Appellee,
Franchise Tax Board

Appendix A

MANAGEMENT THEORY:
SELECTED EXCERPTS

THE DECENTRALIZED PATTERN

[Excerpts from: John Pfiffner and Frank Sherwood, Administrative Organization, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1960, pp. 189-196.]

The contemporary trend in large-scale organization is toward decentralization, but we must realize that decentralization is several things to different people. There are those who view it entirely in terms of decision-making; others see it from the standpoint of geographical dispersion of plants and installations; and still others approach it as a philosophy of corporate life, a set of organization values with sociological, psychological and spiritual facets.

Although the current wave of conversions to the "gospel" of decentralization seems to have started during and after World War II, there was a flurry during the 1920's marked by the emergence

of perhaps the greatest of the prophets, Alfred P. Sloan, Jr., and his enduring monument, General Motors.

II THE DECENTRALIZATION PATTERN IN OUTLINE

An overview in outline at this point may give the reader an understanding of the whole pattern of decentralization before we proceed to a fuller discussion of its parts.

I. The Formal Structure
   - A. A flat job-task pyramid
     1. Minimize number of horizontal levels
   - B. Distinguish between corporate and production levels
     1. Corporate level keeps out of production
     2. Establish semi-autonomous subsidiary corporations or divisions as the principal

operating units

C. Staff-and-line

1. Structure formal authority according to the staff-and-line model postulated in the preceding chapter

D. Set up organization planning as an instrumentality of dynamic growth and change.

II. Executive Behavior

A. Corporate executives

1. Major efforts devoted to planning, policy-making and evaluation of results

2. Refrain from that type of interference in current production matters which weakens subordinates

* * *

3. Set broad goals and targets

4. Control by remote feedback rather than immediate supervision

B. Production Executives

1. Function as autonomous head of own unit
2. Operate on flexible budget making executive virtually an entrepeneur; cost centers, allocating profit-and-loss, extend down into the plants
3. Make and implement policy subject to guide lines established at the corporate level
4. Delegate and then absorb heat generated by subordinates' errors
5. Plan production goals and controls by feedback

6. Generate atmosphere of self-reliance within a framework of freedom in which the main sanctions are results

III. Policy and Decision

A. Board guide lines are established at corporate level

B. There is a policy continuum in which each subordinate level determines policy in line with that set by superior echelons

C. Decisions are made at the lowest level consistent with the situation

D. Decisions are arrived at only after completed staff work and consultation, but the responsibility for decision

resides with the appropriate executive

E. The superior behaves in such a manner as to encourage subordinates to make decisions, parrying attempts to evade responsibility

IV. The Social Climate

A. Relaxed freedom within the rules of the game

B. Communication is two-way, oblique, and horizontal

C. Democratic consultation and interaction without undermining the essential needs of leadership and discipline

D. Individual self-expression and self-development are encouraged within the limits imposed by organization's resources and needs

III THE DECENTRALIZATION PATTERN IN DETAIL

The Formal Structure

Two general approaches. There are in general two ways of decentralizing an industrial structure. One is by leaving the decentralized units as integral divisions, there being only one corporation. In general this is the policy followed by General Motors. The other is to decentralize by the organization of subsidiaries, or affiliate companies. The Standard Oil companies have tended to follow the latter method.

Three bases of decentralization. Smith's study found three general types of decentralized structure in American industry: (1) by functions; (2) by geographical regions; and (3) by product divisions. Firms organized by function tend to have one main product. In them

the decentralized factory manager and sales manager each report to separate functional executives at headquarters, as would other functional people, such as finance. This type of organization has three vertical levels, and the people working in it seem to be less confused about status because it is clear to whom they report.

In the second, an organization based on geographical decentralization, everyone reports through the regional manager. Functional lines to headquarters are purely staff, similar to the line-and staff model postulated in the previous chapter. Such organizations tend to have four levels. In spite of the fact that this is the type of organization postulated by our model for large comapnies with diversified products, Smith points out that it seems usual "to have strong differences of opinion between the headquarters

officers, on the one hand, and the branch officers, on the other, as to who should have authority to do what." This is only one more example of the fact that the decentralized way of life may not be the easiest one.

Organization by product line is represented by the Ford Motor Company, General Motors, and Du Pont. In each case a major division is devoted to making and selling a single product. Each division is organized as an independent unit and the structure of the field units may be functional, geographical, or a mixture of the two. Committees at the corporate level work toward desirable standardization and uniformity.

FEDERAL DECENTRALIZATION

[Excerpts from: Peter F. Drucker, Management: Tasks, Responsibilities, Practices, Harper & Row, New York, 1974, pp. 572-579.]

In "federal decentralization" a company is organized in a number of autonomous businesses. Each unit has responsibility for its own performance, its own results, and its own contribution to the total company. Each unit has its own management which, in effect, runs its own "autonomous business."

Federal decentralization (as has been mentioned earlier, in Chapter 41) was first worked out, though only crudely, by Pierre S. de Pont in 1920 in the reorganization of the family-owned Du Pont Company, which had outgrown, during World War I, an older functional structure. When Pierre S. du Pont, shortly thereafter, took over the presidency of General Motors, which was

then in desperate trouble, he found that Alfred P. Sloan, then GM's executive vice-president, had arrived at a similar, though far more polished version. Sloan's "decentralized operations with centralized policy control"—put into effect during 1921-22—became the prototype of decentralization. Among the many imitations and adaptations, the one made in 1950-52 for the reorganization of the General Electric Company became, in the years of the "management boom," the standard model worldwide.

* * *

The Strengths of Federal Decentralization

Of all design principles available so far, federal decentralization comes closest to satisfying all design specifications. It also has the widest scope. Both operating work and innovative work can be organized as decentralized

autonomous businesses. And while top management can obviously not be set up as an autonomous business, federal decentralization of the business, if done properly, makes for strong and effective top managements. It frees top management for the top-management tasks.

The Requirement of
Federal Decentralization

Decentralization must not create a weak center. On the contrary, one of the main purposes of federal organization is to strengthen top management and to make it capable of doing its own work rather than be forced to supervise, coordinate, and prop up operating work. Federal decentralization will work only if the top-management job is clearly defined and thought through.

* * *

In other words, there must be a kind of "supremacy clause" reserving

to central management the decisions that affect the business as a whole and its long-range future welfare, and allowing central management to override, in the common interest, local ambitions and pride.

Specifically, there must be three reserved areas if the business is to remain a whole rather than splinter into fragments. Top management, and top management alone, can make the decision what technologies, markets, and products to go into, what businesses to start and what businesses to abandon, and also what the basic values, beliefs, and principles of the company are.

Second, top management must reserve to itself the control of the allocation of the key resource of capital. Both the supply of capital and its investment are top-management responsibilities which cannot be turned over to the autonomous units of a federal organization.

The other key resource is people. The people in a federally organized company, and especially managers and key professionals, are a resource of the entire company rather than of any one unit. The company's policies with respect to people and decisions on key appointments in the decentralized autonomous businesses are top-management decisions—though of course, autonomous business managers need to take an active part in them. And a decentralized company needs to have a strong, respected, and senior executive in top management who is the company's conscience with respect to people.

Top management in a decentralized structure has to be separate. It cannot also run any of the autonomous businesses no matter how big or important they are.

Appendix B

CONTAINER CORPORATION OF AMERICA FORMER CCA EMPLOYEES WORKING FOR FOREIGN SUBSIDIARIES

[Exhibit D to Stipulation of Facts in Evidence]

Name, company, position, and date foreign employment commenced.

Frank Angeles	Cartoenvases de Mexico, Mexico City Art Director - D September 1962
Otto H. Atkinson	Cartoenvases de Mexico, October 1963
Louis M. Crandall	Carton y Papel, corrugated Carton y Papel, Reforma Division Manager - D August 1963
Donald D. Hartman	Carton y Papel, Reforma General Manager - P October 1958
John T. Hutton	Carton y Papel, Los Reyes General Manager - P May 1963
Melvin L. Johnson	Carton y Papel, Los Reyes General Manager - P December 1960
Carl Philhower	Carton y Papel, Cerro Gordo Plant Manager - P November 1958

Ernest A. Robinson	Cartoenvases de Mexico, Mexico City General Manager - D July 1959
Stanley B. Tamkin	Carton y Papel, Reforma Vice President - C September 1959
William D. Thorpe	Carton y Papel, Corrugated Plant Manager - P February 1961
Epigmenio Guzman	Carton y Papel, Corrugated April 1961
Ernest W. Briggs	Carton de Colombia, Cali Staff Engineer - P January 1966
Francis J. Sauer	Carton de Colombia, Cali General Manager - P April 1962
T. J. Hosted	Carton de Colombia, Cali Controller - P May 1965
Edward N. Jacobs	Carton de Colombia, Cali Director of Manufacturing - D August 1950

Stanley Karpinski	Cartones Nacionales, Valencia February 1961
Jerry Sanders	Fibras, Caracas Resident Manager - P April 1960
Donald C. Corse	Cartones Nacionales, Valencia Division General Manager - D September 1952
Robert F. Donegan	Union Grafica, Caracas Vice President - C April 1961
Gordon Healea	Cartones Nacionales, Valencia Plant Manager - P March 1964
John Manzella	Carton de Venezuela, Petare Division General Manager - D December 1955
Delos G. Morton	Cartones Nacionales, Valencia General Controller-C June 1959
Glendie E. Osborne	Carton de Venezuela, Petare Mill Manager - P January 1963

Robert G. Ridings	Cartones Nacionales Valencia General Manager - P August 1963
Russell W. Wilson	Union Grafica, Caracas Director of Marketing - D July 1962
Richard A. Witte	Europa Carton, Heppenheim General Manager - P September 1957

C - Corporate
D - Division
P - Plant

Appendix C

Source Variations Computed on the Basis of Taxable Income

On page 16 of Appellant's Brief, various figures are set forth by Appellant to demonstrate the amount of foreign income allegedly erroneously apportioned by California to itself and the United States. Appellee does not believe that Appellant's analysis is relevant in context of the unitary theory and in any event is not probative given the admitted inaccuracies of separate accounting data in this case. Nonetheless, the Court should be aware that Appellant's calculations are based upon financial or book income (profits on JA:E Ex A-1 through A-6) not on taxable income as defined by California. As a result, Appellant has overstated the alleged misapportionment. If the Court wishes to consider the arguments raised by Appellant in the context of consistent and correct figures,

respondent respectfully suggests the following substitutions:

	1963	1964	1965
	1,470,105	4,675,478	3,660,163
1. Worldwide income apportioned to California	3,355,141	3,835,868	3,704,499
2. Domestic income apportioned to California	3,243,891	3,323,252	3,316,892
3. Increase of 1 over 2	141,250	512,616	387,607

These figures were computed on the following basis:

The first set of figures were calculated by Multiplying the United States Apportionment Factors times Adjusted Unitary Business Income JA:E Ex A-7 and Subtracting United States Source Income.

The figures on 1. were calculated by multiplying California Worldwide Apportionment Factors times Adjusted Unitary Business Income JA:E Ex A-7.

The figures of 2. were calculated by multiplying California Domestic Apportionment Factors Times the Total of Unitary Business Income per Return and Federal RAR Adjustments JA:E Ex A-7.

The various items involved in these calculations are defined as follows:

California Domestic Apportionment Factors

CCA Calfornia Factors JA:E Ex A-2, A-4, A-6 ÷ CCA Factors JA:E Ex A-2, A-4, A-6

California Worldwide Apportionment Factors

CCA California Factors JA:E Ex A-2, A-4, A-6 ÷ CCA Factors JA:E Ex A-2, A-4, A-6 + Total Factors JA:E Ex A-1, A-3, A-5 (Property & Payroll) and Combined CCA Sales JA:E Ex A-2, A-4, A-6 + Total Sales JA:E Ex A-1, A-3, A-5

United States Apportionment Factors

CCA Factors JA:E Ex A-2, A-4, A-6 (Property & Payroll) and Combined CCA Sales JA:E Ex A-2, A-4, A-6 ÷ Denominator Figures for Worldwide Above

United States Source Income*

Unitary Business Income per Return JA:E Ex A-7 + Federal RAR adjustments JA:E Ex A-7

*An even more appropriate comparison would be Income Subject to Tax by the IRS Adjusted to a California Tax Base which equals Federal Taxable Income per Form 1120 JA:E

Ex A-7 + RAR Adjustments JA:E Ex A-7 + State Taxes Based on Income JA:E Ex A-7 + Interest on Government Obligations JA:E Ex A-7. On this basis, the first set of figures on page 16 of Appellant's Brief would be:

1963	1964	1965
961,922	2,464,394	(1,215,898)

Appendix D

Nos. 52818, 52828, 52903

IN THE SUPREME COURT OF ILLINOIS

CATERPILLAR TRACTOR CO.,
CATERPILLAR AMERICAS CO.,
CATERPILLAR CREDIT CORP.,
CATERPILLAR FINANCE CORP.,
and CATERPILLAR MACHINERY CORP.,

Plaintiffs-Appellants,
Cross-Appellees,

v.

ILLINOIS DEPARTMENT OF REVENUE,
et al,

Defendants-Appellants,
Cross-Appellees,

and

COCA-COLA COMPANY, et al,

Intervening Plaintiffs-
Appellants.

On Appeal from the Appellate
Court of Illinois, Third District,

No. 79-104

There Heard on Appeal from the
Circuit Court of the Tenth
Judicial Circuit, Peoria County
Illinois.

Case No. 78L5615

Honorable
Stephen J. Covey,
Presiding Judge

BRIEF OF AMICI CURIAE

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ORAL ARGUMENT REQUESTED

[The following pages contain only Argument I of the brief.]

ARGUMENT

I.

COMBINED REPORTING IS REQUIRED TO FAIRLY APPORTION INCOME OF A UNITARY BUSINESS

Where a unitary business is conducted through a number of separate corporations, each corporation in the group will generally maintain separate accounting records. Opponets of the combined method of apportionment argue that the existence of such separate records solves the problem of allocating specific items of income and expense to different segments of a unitary business. They conclude that apportionment on a separate basis (corporation by corporation) is the appropriate method for dividing the income of a multicorporate enterprise among the states in which it operates.

There are at least two basic reasons why apportionment on a separate

basis in unsound for a truly unitary business. First, apportionment on a separate basis would be extremely difficult, and often impossible, to administer fairly. Second, apportionment on a separate basis does not result in a fair distribution of profits and losses of individual members of a unitary business among all members of the group.

A. Apportionment on Separate Basis Cannot Be Policed

Any failure to maintain arm's-length dealings in transactions between members of a multicorporate unitary business will result in distortion of the income of the individual members. With combined reporting, the potential problem of distortion is eliminated by combining the income of each member of the unitary group prior to apportionment. If apportionment is made on a corporation by corporation basis, however, any distortion

is preserved. Thus, if apportionment on a separate basis is permitted, the Department must closely police all transactions between members of the unitary group to insure that the transactions are conducted at arm's length.

If apportionment on a separate basis is permitted, some taxpayers may be tempted to manipulate prices in order to reduce tax liability in the taxing state. Although a taxpayer is entitled to structure its transactions to reduce its tax liability, it may not do so by arbitrarily assigning non-arm's-length prices to its goods or services. Without combined reporting, the Department might be forced to sort through thousands of transactions to determine the proper income of a single unitary business.

While the overwhelming majority of taxpayers make every effort to comply with the tax laws, it is often very

difficult to determine proper pricing of intercorporate transactions and there will inevitably be many good faith disagreements between taxpayers and revenue collection agencies. Policing of transactions between related companies to insure that they are arm's-length is particularly difficult when there is a lack of competitive pricing information. In some instances, a product may be unique (e.g., a manuscript, motion picture, or master recording) and information on property of a similar type may not be very helpful in determining an arm's-length price. In other instances, a product may be transferred at an interim stage in the manufacturing process when no similar sale would be made by unrelated parties, and thus no arm's-length price would be available. Thus, even after the non-arm's-length transactions are identified, the Department may still have

difficulty in determining a proper arm's-length price.

The scope of the problem of policing transactions between related parties is shown by the myriad cases under Section 482 of the Internal Revenue Code, which allows the Internal Revenue Service to reallocate various items among separate corporations in order to clearly reflect the income of the corporations for Federal income tax purposes. One commentator has noted that such policing at the state level "would require an army of agents greater than the total number of agents employed by all the states and the Federal Government combined."*

Accordingly, permitting a unitary group of corporations to report

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*Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practices, 42 J. Taxation 106 (1975).

income or a separate basis will create substantial administrative burdens for the Department and will prevent fair enforcement of the law. The Court should require combined reporting so that the Department will not be forced to rely on a hit-or-miss method of determining the amount of income attributable to Illinois.

B. Unitary Method Essential for Fair Allocation of Profits and Losses

Even if the state could determine that all transactions among members of a unitary group were conducted at arm's length, reporting the income of each corporation on a separate basis is still inappropriate for a unitary business. The cornerstone of unitary apportionment is the assumption that the various segments of a unitary business are interrelated and vital parts of the whole business. Even

though a portion of a unitary business may only break even or even be unprofitable on a separate basis, it may contribute to the profitability of the larger enterprise in numerous ways which may not be recognized under any separate accounting system.

The courts of several states have recognized that a unitary business is inseparable even where segments of the business are separately incorporated. The Supreme Court of California concluded in the leading case of Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), that a California subsidiary corporation, engaged in selling merchandise, contributed to the profits of the whole unitary enterprise in the same way that a California branch contributed to the profits of the unitary business in Butler Brothers v. McColgan, 315 U.S. 501

(1942), i.e., by enabling the enterprise to obtain more favorable prices on its purchases. Thus, the court applied combined formulary apportionment to the business despite a finding that the subsidiary corporation's separate accounts were reasonable and accurate.

Contributions to a unitary enterprise may even be less tangible: a member of the unitary group may be an excellent training ground for management personnel who later work for another member of the group; a member of the unitary group may serve a role in attaining a "national" status for the unitary enterprise.

The impossibility of identifying, let alone quantifying, the contributions of a segment of a unitary business to the enterprise as a whole makes reporting on a separate basis undesirable. Thus,

combined reporting provides a better means of achieving the legislature's goal of an equitable method of apportionment.

II.

COMBINED REPORTING APPROPRIATELY STRESSES SUBSTANCE OVER FORM

Intervenors concede that formulary apportionment is proper under the Illinois Income Tax Act. However, they argue that where a unitary group member is a separate corporate entity, formulary apportionment should apply to that corporation separately. Amici Curiae contend that because of the interdependence of the entities which make up the unitary group combined reporting is essential to achieve a fair apportionment of income. This interdependence exists whether the unitary group is made up of corporate or noncorporate entities. Accordingly, formulary apportionment should apply on

a combined basis.

The application of formulary apportionment to each corporate member of a unitary group on a separate basis would elevate form over substance. Assuming that the enterprise is unitary, its tax liability should be the same whether it is structured (i) as a single corporation consisting of separate divisions, or (ii) as a multicorporate enterprise in the form of a parent corporation with separate subsidiary corporations. In applying formulary apportionment Intervenors would distinguish (i) from (ii). In situation (i), they would combine the separate divisions of the single corporation and apportion the divisions' income as a unit. Yet in situation (ii), Intervenors would treat the parent corporation and each of its subsidiaries separately. They would

apply formulary apportionment to the parent corporation on a separate basis and to each subsidiary corporation on a separate basis. The emphasis on structural form in Intervenors' argument is apparent.

The Illinois Income Tax Act should be interpreted so that the taxpayer's decision whether to operate his business as a corporation with divisions or a corporation with subsidiaries is made on the basis of economic and not tax considerations. Separate reporting might encourage some taxpayers to fracture their business into subsidiaries solely because of the advantage gained under the Illinois Income Tax Act.

The following example illustrates the consequences of ignoring the substance of the unitary enterprise and stressing its structural form.

EXAMPLE

Widget Corporation, Inc. is an Illinois corporation engaged in the manufacture and sale of widgets. Widget Corporation, Inc. has a separate unincorporated division, Western Widget Division, which conducts all sales operations for Widget Corporation, Inc. on the West Coast of the United States. Widget Corporation, Inc., also has a wholly-owned subsidiary corporation, Eastern Widget Subsidiary, which conducts all sales operations for its parent corporation on the East Cost of the United States.

The operations of Eastern Widget Subsidiary are identical to those of Western Widget Division. Neither Western Widget Division nor Eastern Widget Subsidiary manufactures widgets. Widget Corporation, Inc. manufactures all of the widgets which are sold by its division and corporate

subsidiary. Widget Corporation, Inc. engages in no sales operations on its own. It is assumed that Widget Corporation, Inc., its division and its corporate subsidiary constitute a unitary business. Western Widget Division and Eastern Widget Subsidiary are completely dependent on Widget Corporation, Inc. for the widgets which they sell.

In a given year, Western Widget Division and Eastern Widget Subsidiary each earn income of $100,000 on sales. Widget Corporation, Inc. earns no income since it sells at cost. (It is recognized that Widget Corporation, Inc. probably should not sell at cost since it normally would be entitled to a manufacturing profit. However, see the discussion of administrative problems in I.A. of the argument at page 8 above). Western Widget Division and Eastern

Widget Subsidiary each have property, payroll, and sales of $200,000, all of which is the result of sales operations outside Illinois. Widget Corporation, Inc. has $200,000 of property, payroll, and sales inside Illinois as a result of the location of its manufacturing facilities there. Table I summarizes the amounts set forth above.*

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*The apportionment formula under the Illinois Income Tax Act is a three factor formula based on property, payroll and sales. For purposes of simplification, this example treats the factors in the aggregate.

TABLE I—FACTS

	Income	Property Payroll Sales Inside Ill.	Property Payroll Sales Outside Ill.
Widget Corporation, Inc.		$200,000	
Western Widget Division	$100,000		$200,000
Eastern Widget Subsidiary	$100,000		$200,000

Under the combined method of reporting, formulary apportionment would apply to the income of the unitary group as presented in Table II.

TABLE II—Combined Reporting

Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary			Income of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary
Illinois and Non-Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary	X		

$\frac{\$200,000}{\$600,000}$ X $200,000 = $66,667 subject to Illinois Income Tax

Income of Unitary Group Subject to Illinois Income Tax = $66,667.

Table III illustrates how formulary apportionment would apply to the unitary group on a separate basis.

TABLE III—Separate Reporting

(1) Application of Formulary Apportionment to Widget Corporation Inc. and its unincorporated division, Western Widget Division.

$$\frac{\text{Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division}}{\text{Illinois and Non-Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division}} \times \text{Income of Widget Corporation, Inc. Western Widget Division}$$

$$\frac{\$200,000}{\$400,000} \times \$100,000 = \$50,000 \text{ subject to Illinois Income Tax}$$

TABLE III (Cont'd)

TABLE III—Separate Reporting
(Cont'd)

(2) Application of Formulary Apportionment to Eastern Widget Subsidiary.

$$\frac{\text{Illinois Property-Payroll-Sales of Eastern Widget Subsidiary}}{\text{Illinois and Non-Illinois Property-Payroll-Sales of Eastern Widget Subsidiary}} \times \text{Income of Eastern Widget Subsidiary}$$

$$\frac{\$0}{\$200,000} \times \$100,000 = \$0 \text{ subject to Illinois Income Tax}$$

Income of Unitary Group Subject to Illinois Income Tax = $50,000.

As Table III illustrates, apportionment of the income of the unitary group on a separate basis results in all of the income earned by Eastern Widget Subsidiary escaping apportionment under the Illinois Income Tax Act, even though the manufacturing facilities upon which this income depends are located within Illinois. On the other hand, all of the income earned by Western Widget Division is subject to the Illinois apportionment formula because it operates as a division of Widget Corporation, Inc. rather than as a subsidiary corporation. Hence, if the income of the unitary group is apportioned on a separate basis, Widget Corporation, Inc. will have benefited under the Illinois Income Tax Act simply by incorporating its East Coast sales operations into a separate corporation.

If the example were altered so that either (i) Widget Corporation, Inc. and Western Widget Division were located outside Illinois while Eastern Widget Subsidiary was located inside Illinois or (ii) Widget Corporation, Inc. was located outside Illinois while Western Widget Division and Eastern Widget Subsidiary were located inside Illinois, a greater Illinois tax liability would result under separate reporting than under the combined method.

The point of this example, however, is not to show that Illinois exacts a greater or lesser tax depending on which method is used. The respective parties would agree there is a difference. Amici Curiae merely wish to illustrate that, given the fact that formulary apportionment has been adopted in Illinois, basing the tax liability of a

group of interdependent and inseperable business activities on whether a particular activity is structured as a separate corporation places a wholly unwarranted emphasis on the structural form of the enterprise.

Courts in other states have recognized that the structural form of the unitary enterprise should not affect the apportionment of income and, therefore, have required use of combined reporting. See, Edison California Stores, Inc. v. McColgan, 183 P.2d 16, 21 (Cal. 1947); Coca-Cola Company v. Department of Revenue, 533 P.2d 788, 792-94 (Ore. 1974); Montana Department of Revenue v. American Smelting & Refining Company, 567 P.2d 901, 908-09 (Mont. 1977). Similar recognition has been accorded in legal commentary. Frank M. Keesling explains that the purpose of the combined

report is to assure that where a business is conducted both inside and outside the taxing state, the business' income will be apportioned in the same fashion whether the business consists of one corporation or multiple corporations. He notes that in both cases the income of the business is computed as a unit, apportioned by applying the appropriate formula, and the amount so apportioned is added to any nonbusiness income which the taxpayer derives from sources within the taxing state. Thus, in determining the amount of business income attributable to a particular state, "no advantage is obtained, and no detriment suffered, as the result of employing a number of corporations rather than one to operate a business," Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practices, 42 J. Taxation

106 (1975).

Furthermore, the United States Supreme Court's recent opinion in Mobil Oil Corp. v. Commissioner of Taxes, 48 U.S. L.W. 4306 (March 19, 1980), reflects unwillingness to permit the structural form of a unitary enterprise to affect issues of taxation. In Mobil Oil, the taxpayer argued that the inclusion, by a non-domicillary state, of dividends received from the taxpayer's foreign subsidiaries and affiliates in the income tax base subject to apportionment violated the Due Process and Commerce Clauses of the United States Constitution. In the context of the taxpayer's due process challenge, the Court refused to draw any distinction on the grounds that the income was received in the form of dividends from separately incorporated entities rather than derived from

intracorporate divisions.* The Court stated:

> "Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. General Motors Corp. v. Washington, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." 48 U.S. L.W. at 4310.

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*Amici Curiae acknowledge that the Court refused to decide whether the Due Process Clause requires combined reporting. 48 U.S.L.W. 4306, n. 15. However, Amici Curiae believe that the Court's distaste for arguments emphasizing form over substance bears noting.

The purpose of formulary apportionment under the Illinois Income Tax Act is to fairly and equitably attribute the income earned by a unitary enterprise to the business activities which it conducts within the State. Amici Curiae submit that fairness and equity cannot be achieved if a distinction is made merely because a segment of the unitary enterprise operates as a separate corporation.

CONCLUSION

In light of the foregoing policy considerations, Amici Curiae respectfully request that this Court affirm that portion of the decision of the Appellate Court which would require the combined method of reporting in the State of Illinois.

Respectfully submitted,

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Appendix E

THE THEORY OF THE UNITARY BUSINESS PRINCIPLE

[Excerpt from International Division of the Income Tax Base of Multinational Enterprise, Publ. Multistate Tax Commission, Geoffry John Harley, 1981, p. 6.]

The unitary enterprise theory rests on economic analysis. Its focus is on the geographic locations of the comp nents of the multinational enterprise itself. It views a group of enterprises under common ownership as components of a single integrated business operation, arranged in a particular way purely to accommodate legal requirements. The central operational premise is that all parts are coordinated by a central management policy and structure which seeks to maximize profits over-all. Accordingly, intercorporate business is irrelevant and profit or loss is determined by transactions with third parties. The intercorporate transactions are

essential factors in producing profit, in the sense that without them, and the peculiar advantages associated with integrated enterprises, there would be no product at the end, but it is the profit itself that counts. The transactions up to the point of sale to the unrelated third party are irrelevant for tax purposes because profit or loss can only be determined when the entire enterprise completes the process of production.

The basic question addressed by the unitary method is how the overall profit of the enterprise is to be assigned, given the fact that separate tax jurisdictions do exist. The separate entity theory requires that profits be assigned to the particular units of the organization in each location. The unitary theory treats the units as being irrelevant; what counts is the extent of the profit

making activity in any given location, based on a measure of territorial contribution, The unitary method seeks to assess what factors of production were located in each country, measuring objectively how much labor was used, how much capital was employed, and where the sales took place. The formula, based on these factors, assigns income to each geographic location on these bases, dividing the entire group's total income among the jurisdictions in which the units happen to be located.

No. 81-523

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

APPELLANT'S REPLY BRIEF

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TABLE OF CONTENTS

	Page
Introduction	1
I. There is no substantial operational interdependence between Container and its foreign subsidiaries; consequently, the due process clause prohibits the taxation of Container and its foreign subsidiaries as a single unitary business	1
A. The FTB and its *amici* disregard the *ASARCO* and *Woolworth* decisions	1
B. The FTB and its *amici* rely entirely on the sweeping California definition of a unitary business, refusing to recognize the definition provided by the court in *Exxon, ASARCO* and *Woolworth* under the due process clause	4
C. The functional integration test of a unitary business responds to the reasons for the resort to apportionment; the flow of goods element of that test provides a badly needed objective standard of apportionment	6
D. Not only does the FTB build its case on an erroneous legal standard, but also its argument is based in substantial part on suppositions and distortions, not on facts of record	7
II. California's apportionment violates the due process clause because it taxes income earned in foreign countries and not in California	11
III. California's apportionment violates the commerce clause because it results in multiple taxation of foreign source income	17
Conclusion	20

TABLE OF AUTHORITIES CITED

Cases

Page

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Chicago Bridge and Iron Co. v. Caterpillar Tractor Co., No. 81-349 18

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F.W. Woolworth Co. v. Taxation and Revenue Department, 50 U.S.L.W. 4957, 73 L. Ed. 2d 819 (1982) 1, 2, 3, 4, 5, 6, 7, 9, 10, 11, 20

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TABLE OF AUTHORITIES CITED

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	Page
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Internal Revenue Code:	
Section 482	10
Section 901	19
Sections 951-964	19

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Parent and Non-100 Percent Owned Affiliates

A list of appellant's parent and non-100 percent owned affiliates is found in Appendix C to the Jurisdictional Statement at A-34, and there have been no changes to that list.

No. 81-523

In the Supreme Court

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CONTAINER CORPORATION OF AMERICA,
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APPELLANT'S REPLY BRIEF

INTRODUCTION

Appellant, Container Corporation of America (Container), will discuss arguments made by Appellee, Franchise Tax Board (FTB), and *amici* supporting the FTB in three areas: (i) the due process clause and the unitary concept; (ii) the due process clause and taxation of extraterritorial income; and (iii) the commerce clause and multiple taxation. Container believes no further argument is necessary regarding its position that worldwide unitary combination violates the commerce clause because it impairs the foreign policy of the United States. The FTB primarily asserts that the Court cannot prevent such interference unless Congress specifically forbids state action. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) and *Zschernig v. Miller*, 389 U.S. 429 (1968) are clear authority to the contrary.

I. THERE IS NO SUBSTANTIAL OPERATIONAL INTERDEPENDENCE BETWEEN CONTAINER AND ITS FOREIGN SUBSIDIARIES; CONSEQUENTLY, THE DUE PROCESS CLAUSE PROHIBITS THE TAXATION OF CONTAINER AND ITS FOREIGN SUBSIDIARIES AS A SINGLE UNITARY BUSINESS

A. The FTB and Its Amici Disregard the ASARCO and Woolworth Decisions

In its opening brief, Container demonstrated that there is no substantial operational interdependence between Container and its foreign subsidiaries. Container argued that under the most recent decisions of this Court, particularly *ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962, 73 L. Ed. 2d 787 (1982), and *F.W. Woolworth Co. v. Taxation and Revenue Department*, 50 U.S.L.W. 4957, 73 L. Ed. 2d 819 (1982), the lack of any substantial operational interdependence prohibited California from taxing Container and its foreign subsidiaries as a single unitary business. Appellant's Br. at 40-49. The FTB and its *amici*, however, ignore the real meaning

of the *ASARCO* and *Woolworth* decisions, claiming that "these decisions are not directly applicable or controlling," Appellee's Br. at 62, and that the issues in those cases were "erroneously resolved." Multistate Tax Commission (MTC) Br. at 22, n.37.

Realizing that their position was untenable under *ASARCO* and *Woolworth*, the FTB and its *amici* chose to ignore the impact of those decisions, and conducted no comparison of the facts in those cases with the facts in the present case.[1] As set forth in Appellant's Brief on the Merits, when the proper factual comparison is made, it is clear that Container and its foreign subsidiaries operated as discreet businesses much like Woolworth and its foreign subsidiaries. Appellant's Br. 42-43. Thus, under *Woolworth* as well as *ASARCO*, Container and its foreign subsidiaries are not a single unitary business.[2]

ASARCO, *Woolworth*, *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980), and *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), all indicate that a state may justify taxing an enterprise as a unitary business only if there exist "factors of profitability" arising "from the operation of the business as a whole." *Woolworth*, 73 L. Ed. 2d 828, quoting *Mobil*, 445 U.S. at

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[1]While California and its *amici* hint that *ASARCO* and *Woolworth* have no relevance outside the area of apportionment of dividends, the Court has indicated that the opposite is true, remanding a case concerning the permissibility of unitary combination for consideration in light of *ASARCO* and *Woolworth*. *Russell Stover Candies, Inc. v. Department of Revenue, vacated and remanded*, 51 U.S.L.W. 3251 (U.S. Oct. 4, 1982) (No. 81-2080).

[2]The FTB ignores the impact of *ASARCO* and *Woolworth* not only in connection with the substantive issue of the definition of a unitary business under the due process clause, but also in its numerous unsupported statements regarding the manner in which this Court should review the decision of the court below. Appellee's Br. 2-5, 45-56. Those statements are unsupported by relevant authority and inconsistent with the obvious care and completeness with which this Court reviewed the records in *ASARCO* and *Woolworth*.

438. These factors of profitability, all of which must exist to a substantial extent, are "functional integration, centralization of management, and economies of scale." *Id.*

In Container's case, "there was little functional integration," as the Court in *Woolworth* defined this element. 73 L. Ed. 2d at 828. The subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations, conducting every element of business operations themselves. Stip. ¶¶ 61, 111-113, 118, J.A. 30, 56-7, 59. In describing functional integration, the Court referred to *Exxon*, where there was a "highly integrated business" involving "a unitary stream of income of which the income derived from internal transfers of raw materials . . . is a part." *Woolworth*, 73 L. Ed. 2d at 828. Container and its foreign subsidiaries do not fit this description.[3]

There was no centralization of management or any other economy of scale. As in *Woolworth*, "each subsidiary operated as a distinct business enterprise at the level of full-time management." *Id.* at 829. The management of the foreign subsidiaries had complete authority and control over day-to-day business decisions. Stip. ¶¶ 127, 130, J.A. 65-66, 67-68. Such business decisions were not reviewed or subject to review by Container. Major policy matters, defined as consisting exclusively of capital appropriations, were also the responsibility of the foreign subsidiaries, but were generally subject to review by Container. Even in matters involving a major capital expenditure, the initiative rested with the foreign subsidiary, and local manage-

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[3]The FTB argues that no transfers of product occurred in either *Exxon or Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Appellee's Br. at 83-85. However, as noted in *ASARCO*, substantial transfers of product were essential to Exxon's business. 73 L. Ed. 2d at 803 n.24. Similarly, the central purchasing of inventory in *Butler Bros.* constitutes the transfer of product and provides the same functional integration and economies of scale as the transfers of raw materials in *Exxon*.

ment reserved the right to forego actual implementation of projects authorized by Container. All other policy matters were the complete responsibility of the foreign subsidiaries. Stip. ¶ 74, J.A. 39-40.

The FTB argues that Container's review and approval of capital appropriations resulted in centralization of management. Appellee's Br. at 23-24, 69-70. However, Container simply reviewed and generally approved such decisions made by the management of the foreign subsidiaries. Stip. ¶ 74, J.A. 39-40. This review and approval did no more than protect Container's interests as an investor in the subsidiaries. Thus, as in *Woolworth*, "[t]here were some managerial links," but these links do not rise to the level of management centralization or achievement of a significant economy of scale. "Except for the type of occasional oversight—with respect to capital structure, major debt and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of these . . . corporations." 73 L. Ed. 2d at 830-31.

B. The FTB and Its Amici Rely Entirely on the Sweeping California Definition of a Unitary Business, Refusing to Recognize the Definition Provided by the Court in Exxon, ASARCO and Woolworth Under the Due Process Clause

The FTB's argument regarding unity is based upon the sweeping premise that "taxpayers [are] operating a unitary business . . . . [i]f the in-state business is dependent upon or contributes to the out-of-state business in any material respect" and that "the due process requirements of unity should be no greater than California's contribution test." Appellee's Br. at 59, 60. The FTB makes no reference to the standards set forth in *ASARCO, Woolworth*, and *Exxon*, and ignores the fact that pursuant to the FTB's standard this Court would have reached a different conclusion with regard to some of the businesses in *ASARCO* and *Woolworth*. For example, in *ASARCO*

one of the subsidiaries, Southern Peru Copper Corp., sold about 35% of its output to ASARCO. 73 L. Ed. 2d at 798. Thus, under the FTB's standard, Southern Peru and ASARCO clearly "contributed" to, and perhaps were "dependent" upon the operations of one another.

Similarly, in *Woolworth*, the parent had common directors with some of the subsidiaries, reviewed all major financial decisions by the subsidiaries, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, and reinvested dividends in some of the subsidiaries. In addition, there was frequent "communication between the upper echelons of management of the parent and the subsidiaries." 73 L. Ed. 2d at 829, 830.[4] Despite any "contribution" which the parent may have made to the operations of the subsidiaries, the Court found that Woolworth was not engaged in a single unitary business with its foreign subsidiaries.

The constitutional deficiency of California's contribution test is aggravated by the FTB's continued reliance on its administrative presumption that companies engaged in the same line of business are conducting a single unitary business. Appellee's Br. at 82. The FTB ignores the fact that defining a unitary business in terms of a sweeping "contribution" test "would destroy the concept." *ASARCO*, 73 L. Ed. 2d at 801. Particularly when applied in combination with an administrative presumption such as California's, "this conception of the 'unitary business' limitation becomes no limitation at all," or is at best "arbitrary." *Id; see also* Appellant's Br. at 44-45. In short, the FTB, *sub rosa*, asks this Court to overrule its recent decisions in *ASARCO* and *Woolworth*.

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[4]The upper echelon of Container's management had significantly less contact with its subsidiaries. *Compare* Stip. ¶¶ 126-130, J.S. 65-68.

C. The Functional Integration Test of a Unitary Business Responds to the Reasons for the Resort to Apportionment; the Flow of Goods Element of that Test Provides a Badly Needed Objective Standard of Apportionment

In giving content to the "functional integration" requirement of a unitary business, the Court in *ASARCO, Woolworth,* and *Exxon* emphasized the substantial flow of raw materials, manufactured products, or inventoriable goods between subsidiaries or divisions of a manufacturing, producing or mercantile enterprise. This implementation of the functional integration test of a unitary business responds to the historical reasons for the development of apportionment. Apportionment was developed by the States because they found it difficult to localize, State by State, by cost accounting or any other method, the profits derived from businesses that manufacture or produce goods in one State and market them in others, or by mercantile businesses that buy goods in one State and sell them in others, and in other integrated industries. Consequently, the States found it necessary to resort to apportionment to divide the income of a unitary business.[5] However, where, as in this case, each of the companies essentially conducted all its basic operations—the production or purchase of raw materials, manufacturing and marketing—within a single country, the profit earned in each country can be determined by looking solely to the operations in that country, without taking into account the operations conducted in other countries. Indeed, to attribute income by the apportionment method in such cases tends to produce the type of misattribution and distortion of income that the facts of the instant case disclose.

In addition to being basic to the underlying reason for formulary apportionment, the substantial flow of goods

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[5] *See* Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," 21 National Tax Journal 487 (1968).

requirement[6] has the further advantage of introducing an objective factor into an otherwise largely subjective determination as to whether the business is unitary. Adopting such an objective standard would reduce the number of cases in which it is necessary to refer to factors such as centralized management and services, which are often not operational in character, but directed to protection of the parent's interest as a shareholder.

D. Not Only Does the FTB Build its Case on an Erroneous Legal Standard, But Also its Argument is Based in Substantial Part on Suppositions and Distortions, Not on Facts of Record

Having ignored the proper test enunciated in *ASARCO* and *Woolworth*, the FTB proceeds to apply its unique view of the facts to its erroneous legal standard. The heart of its factual argument is a forty-six page review of sixteen items which the FTB contends demonstrate Container's "contribution" to its foreign subsidiaries. Appellee's Br. 5-36, 68-83. Some of the items do not show any contribution by Container at all.[7] The others either show only that Container took precautions to protect its interest as an investor,[8] or that Container took no significant role

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[6]A flow of goods or products needs to be substantial to make the business unitary, but that is not an issue in the instant case. Here there is no need to determine what constitutes a substantial flow of goods or products since by any standard the flow of goods and products between Container and its subsidiaries was so inconsequential as not to be substantial. Appellant's Br. at 4.

[7]*E.g.*, Item 2 refers to procedures Container established for the subsidiaries to use in transmitting financial reports from their own complete accounting records to Container. Item 5 shows that Container and the subsidiaries used different law firms and that Container's general counsel spent part of his time handling Container's (not the subsidiaries') international legal affairs. Appellee's Br. at 69, 71.

[8]*E.g.*, Item 1 refers to procedures in acquiring or forming new subsidiaries. Item 4 refers to auditing by an accounting firm. Item 5 discusses loans by Container to the subsidiaries. Item 15 mentions the review by Container's management of capital appropriations. Appellee's Br. at 69, 71, 77.

in the operations of the subsidiaries (these are discussed hereinafter). Moreover, in order to make these items seem important the FTB has overstated or misstated the facts in a number of instances.[9]

A typical example of overstatement is found in Item 12 of the FTB's list, at page 75 of its brief, where it attempts to demonstrate that "the paperboard/packaging function was integrated under CCA's control." In support of this contention the FTB states that Container contracted to "and did, provide all technical, management and other assistance needed by the subsidiaries to function in that business." Appellee's Br. at 75. This statement is contradicted by the Stipulation. The FTB's effort to support its position by reference to the contracts to provide technical services (*i.e.*, Technical Service Agreements) ignores this

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[9]There are two particularly offensive misstatements. First, on page 69 of its brief the FTB sets out what purports to be a quotation from paragraph 28 of the Stipulation of Facts as support for its contention that "site selection and expansion of markets was [sic] centrally controlled." What the FTB has set forth as a quotation, however, appears nowhere in the record, but is instead a description which has been created by the FTB and represented to this Court to be part of the Stipulation of Facts. Moreover, the actual language of paragraph 28 of the Stipulation of Facts, J.A. 16-17, shows that there is no mention of any review or control over site selection, nor does the paragraph refer to a direct market expansion by an existing subsidiary. Instead, the paragraph explains the procedures followed in acquiring or forming new subsidiaries and expanding markets by that means.

Similarly cavalier treatment of the record is found elsewhere. Thus, on page 70 of its brief the FTB contends that Container centralized and integrated financial planning for its foreign subsidiaries, and quotes the Stipulation as stating, "The budgets were submitted to CCA . . . . These were usually reviewed by CCA in connection with its annual meeting." Convenient use of ellipsis aids the FTB here, since the omitted language states that the budgets were submitted to CCA "for information *but not specific approval.*" Stip. ¶ 134, J.A. 70 (emphasis added). Elsewhere paragraph 134 states that, "During these years there was little profit planning," and that the subsidiaries' directors had final approval of capital projects and substantial control over borrowing funds. *Id.*

stipulated evidence.[10] Very little in the way of technical assistance was provided pursuant to the Technical Service Agreements, even though those agreements were worded very broadly. Furthermore, such agreements were not entered into with the important Colombian and Venezuelan subsidiaries. Stip ¶ 146, J.A. 76.[11]

The FTB makes an additional overstatement by its repeated references to Container's "concession" that the fair

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[10]Container offered little material assistance in developing techniques for processing raw material and for adapting machinery to different grades of paperboard. Stip. ¶¶ 76, 84, 85, 146, J.A. 41, 44-5, 45-6, 75-6. Similarly, Container had little or no role in the production of paperboard-based packaging by its subsidiaries, since the functional and graphic designs of the packages which Container manufactured were generally ill-suited to the products and markets served by the foreign subsidiaries. Stip. ¶¶ 56, 57, 66-70, 73, J.A. 27-8, 34-7, 39.

Furthermore, the provision of technical services by ASARCO to its subsidiaries appears to have been far more significant. Exploration services were provided on a centralized basis. ASARCO Joint Appendix at 90. In addition, ASARCO's central research department made its findings available to all of the subsidiaries. *Id.*

[11]Similarly overstated are the FTB assertions that "CCA provided a centralized source of key personnel" and that "centralized personnel training at CCA was provided." Appellee's Br. at 73. *Compare*, Stip. ¶ 119, J.A. 60-1 (limited number of former Container employees employed by foreign subsidiaries); Stip. ¶ 123, J.A. 64 (difficulty of adjusting to foreign countries); Stip. ¶ 132, J.A. 69 (no U.S. training program for foreign subsidiaries).

There are other examples of overstatements. Item 10 (Appellee's Br. at 74) alleges that key subsidiary employees "in substance" remained employees of Container. In fact, this was done as a service to a few employees; at *their* request Container paid them in dollars due to special circumstances. Container was reimbursed by the subsidiaries for both the payroll costs and Container's accounting costs. Stip. ¶ 125, J.A. 65. There is no evidence Container controlled these employees. Container's efforts to accommodate these employees is comparable to Woolworth's action in keeping some employees of the Spanish and Mexican subsidiaries in the parent's pension plan. *Woolworth* Joint Appendix, pp. 50-51. In fact, Woolworth itself made contributions to the plan on behalf of these employees. *Id.*

market value of some of the services it provided to subsidiaries could not be determined. *See, e.g.,* Appellee's Br. at 81-82. However, the Stipulation makes clear that in those instances charges were made by apportioning "the overhead of the relevant staff department".[12] Stip. ¶ 144, J.A. 74-75. Furthermore, the FTB has stipulated that all reasonable charges for services and other items which should have been made were in fact made. The parties stipulated that the figures in Exhibits A and B to the Stipulation, including the net incomes of Container and the subsidiaries "are accurate." Stip. ¶ 21, J.A. 11. For the net income figures to be "accurate" they must obviously take into account all adjustments which would be appropriate

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[12]The FTB's claim that in some instances reasonable charges were not made by Container to the subsidiaries is unimpressive. See Appellee's Br. 32, *et seq.* Reference is made to the fact that Container charged inadequate interest on certain loans to foreign subsidiaries. The effect of such "loans" is thus similar to Woolworth's policy of reinvesting dividends in its German subsidiary. 73 L. Ed. 2d at 829 n.14; Woolworth Joint Appendix at 31, 51. As to the remainder of the claimed undercharges, it is questionable whether Container should have made any charges at all, or, if they should have been made, whether the revised charges would have made any significant difference in determining the net income of Container or the subsidiaries. It is stipulated that "no adjustments to income or deductions pursuant to Internal Revenue Code Section 482 were proposed by the Internal Revenue Service" for the years in issue. Stip. ¶ 151, J.A. 78-79. Furthermore, one of the claimed undercharges is incorrect; the Colombian subsidiary repaid the advances made by Container and the Colombian government to the joint venture discussed at Stip. ¶ 158, J.A. 81-82. In addition, even if a reasonable charge had not been made in certain instances, this would not indicate, as the FTB contends, that a single unitary business existed under the standards enunciated by this Court. Rather, such a fact would indicate that the IRS and/or the FTB might have grounds for adjusting the income of Container and the foreign subsidiaries in accordance with normal separate accounting, arm's-length principles, pursuant to Section 482 of the Internal Revenue Code and Section 24725 of the California Rev. & Tax. Code. *See* Hellerstein and Hellerstein, *State and Local Taxation*, 501-02 (4th ed. 1978).

under the separate accounting, arm's-length method. It is far too late in the day for the FTB to challenge the stipulated figures.

While in this case, as in *ASARCO* and *Woolworth*, there are undoubtedly some ways in which a parent contributed to its foreign subsidiaries, the FTB's list of alleged contributions is not an accurate representation of any such contributions, and, even if it were, it does not demonstrate any substantial operational interdependence. A review by this Court of the Stipulation and the other evidence of record contained in the Joint Appendix will demonstrate that "*no* phase of any subsidiary's business was integrated with the parent's," 73 L. Ed. 2d at 828, so that the FTB may not tax Container and its foreign subsidiaries as a single unitary business.

II. CALIFORNIA'S APPORTIONMENT VIOLATES THE DUE PROCESS CLAUSE BECAUSE IT TAXES INCOME EARNED IN FOREIGN COUNTRIES AND NOT IN CALIFORNIA

Container's opening brief demonstrated that world-wide unitary combination frequently (including in this case) misapportions income to the United States members of a unitary group, resulting in extra-territorial taxation in violation of the due process clause. In an effort to confuse this issue, the FTB and its *amici* have disputed Container's analysis, notwithstanding that it is based upon stipulated figures. Before answering the arguments of the FTB and its *amici*, certain undisputed facts should be reviewed.

1. For the years in dispute, the FTB determined an additional franchise tax liability for Container by adding approximately $41 million of foreign subsidiary income to the apportionable tax base. J.A. Ex. 7. The FTB used the book income of the subsidiaries (taken from the federal income tax Forms 2952) in computing this sum. Stip. ¶ 21, J.A. 11-12.

2. Formulary apportionment determines the income of each member of the group by multiplying the apportionable base by the factors attributable to each member of the group. The effect of formulary apportionment in this

case is to apportion about half the income of the most profitable subsidiaries in Colombia and Venezuela away from those subsidiaries to Container, principally, and to a lesser extent to certain European subsidiaries. Stip. re Testimony, Sched. VI, J.A. 109-113; Appellant's Br. 17.

3. The foreign subsidiaries filed income tax returns in the countries in which they were located on a separate accounting basis and paid substantial taxes to those countries. Stip. ¶¶ 140, 159, J.A. 72, 83-4.

4. The net incomes of Container and the subsidiaries on a separate accounting basis are set out in the record and stipulated by the parties to be accurate. Stip. ¶ 21, J.A. 11-12.

As a first attack upon Container's due process argument, the FTB argues that separate accounting can never be used to impeach formulary apportionment, citing, *inter alia, Exxon Corp. v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980), and *Butler Bros. v. McColgan,* 315 U.S. 501 (1942). However, this Court has endorsed use of separate accounting analyses to impeach formulary apportionment in *Norfolk & Western Railway Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968), and *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123 (1931). *See Moorman Manufacturing Co. v. Bair,* 437 U.S. 267, 272 (1978); *see also Exxon,* 447 U.S. at 233. Of course, the Court has held that in order to invalidate a formula the taxpayer must do more than simply present its own separate accounting analysis; the taxpayer must also introduce evidence explaining why the formula is inadequate and produces an unfair result. The taxpayers introduced such evidence in the *Hans Rees'* and *Norfolk* cases and Container has done so here.[13]

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[13] In its opening brief, Container argued that under these circumstances, at a minimum, the burden of proof shifts to the state, as the Court held in *Norfolk.* Appellant's Br. at 20. The FTB has offered no response to this argument—nor did the FTB offer any evidence at trial to meet its burden.

Container has explained the inadequacy of the formula by showing that the subsidiaries operated under political and economic conditions quite different from those in the United States, particularly in regard to the subsidiaries in Colombia and Venezuela; that the cost of labor is significantly less in those countries than in the United States; that those subsidiaries are much more profitable than Container, and that their factors, particularly payroll and sales, realize a considerably greater return than do those of Container. Appellant's Br. 11-21. The FTB has not denied these basic facts. Nor has the FTB disputed that U.S. businesses use a higher "hurdle rate" in making investments in foreign countries and that this greater rate of return is generally achieved. Thus, Container's explanation for the unfairness resulting from combined apportionment on a unitary basis remains unchallenged.[14]

The FTB next argues that even if separate accounting may be used to impeach the formula, the separate accounting figures in the record are not accurate. Appellee's Br. at 96-8. As stated above, however, the parties have stipulated to the accuracy of the figures in Exhibits A and B and in making this stipulation the FTB was well aware of the charges made by Container for whatever services it provided the subsidiaries. The parties are bound by those figures.

The FTB next attempts to justify the taxation of income earned outside California on the ground that the extraterritorial income apportioned to California is not substantial in amount and that formulary apportionment need only achieve a "rough approximation" in apportioning

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[14]It must also be kept in mind that Container's use of the separate accounting method was not solely a matter of internal convenience, as in *Exxon* and *Butler Bros.* A separate accounting computation was required of Container by the Internal Revenue Code, and of the subsidiaries by the tax laws of the countries in which the subsidiaries operated. *See* Stip. ¶¶ 140, 151, J.A. 72, 78; Appellant's Br. 25 n. 11.

income to the State. *E.g.*, Appellee's Br. at 98. However, under the FTB's method, about half of the income of the most profitable subsidiaries (Colombia, Venezuela and Holland) would be apportioned away from those subsidiaries and, principally, to Container. In fact nearly 30 percent of all the income of the foreign subsidiaries is apportioned to Container. Appellant's Br. at 17. This hardly amounts to "rough approximation."[15] The FTB has not attempted to defend this bald reallocation of income earned outside California. Under these circumstances *Hans Rees'* and *Norfolk* require a holding that the FTB's method of apportionment violates due process.

There is a further consideration in regard to the "rough approximation" rule. The Court's statement that apportionment is satisfactory if it roughly approximates income earned in the State has been applied mainly in the context

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[15]The FTB complains that the computation on page 16 of Appellant's brief is not based on "tax" figures, and the MTC appears to make a similar complaint in regard to the chart on page 17 of Appellant's Brief. (Appellee's Br. 36; MTC Br. 18-19) Container used the net income and apportionment figures appearing in the record and which were stipulated to be accurate. J.A. Exhibits 1-6; Stip. ¶ 21, J.A. 11. These figures are taken from the books of the subsidiaries and Container. The tax figures for Container are set forth at J.A. 7. Container used book figures because the FTB used the book figures of the subsidiaries in computing Container's worldwide income. Stip. ¶ 21, J.A. 11. Because, as the record shows, taxable net income may vary somewhat from book net income (Stip. ¶ 161, J.A. 85), Container maintains that a valid comparison can only be made by using Container's income derived from its books and the book income of the subsidiaries. However, if Container's taxable net income is used, the results do not vary greatly. It is still clear that the formula method reapportions almost half of the income of the Colombian, Venezuelan and Dutch subsidiaries away from those countries and principally to Container. *See* Appendix A.

of interstate commerce. Here we are concerned with *foreign* commerce, where, as the Court said in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 455-6, "true apportionment does not exist and cannot be policed by this Court at all." Thus, the efforts by the states to tax income earned outside their borders should be guarded against more vigorously in connection with foreign commerce than interstate commerce.

The FTB next argues that even if the facts show different rates of return for the factors as between Container and its foreign subsidiaries, this does not impeach formulary apportionment. The FTB attacks Container's statement that formulary apportionment is based upon the premise that a dollar of payroll or property expended or used in one state and a dollar of sales realized in one state typically produce roughly the same amount of income as a dollar so spent or sales realized in another state. Appellee's Br. at 99-100. The premise, however, is confirmed by the leading commentators on state and local taxation.[16] Furthermore, a moment's reflection will show that the premise must be correct. After all, the three-factor formula cannot validly operate over a substantial period of time if the return on payroll, property or sales in one geograph-

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[16] Hellerstein & Hellerstein, *supra* note 12, at 539 states:

> The underlying premise of formulary apportionment under the Massachusetts three-factor formula is that (using UDITPA as illustrative), by and large, every dollar of wages or property spent in one taxing jurisdiction, along with receipts from sales in the area, will produce the same amount of profit in all taxing jurisdictions. Wide disparities in unit labor or unit property costs between taxing jurisdictions tend to attribute to the high wage-property cost jurisdictions, such as the United States, income which is attributable to other jurisdictions. . . .

ical area will be much less or much greater than in another geographical area.[17]

The FTB cites an article which argues that a return on investment analysis may be inappropriate for evaluating the performance of the management of foreign subsidiaries. Appellee's Br. at 103-07. To the extent that commentary has any relevance here, the record in this case is to the contrary. Professor McDonald testified that he reviewed the return on investment analysis in Schedule VI to the Stipulation re Testimony (J.A. 109-13), and that the method used is appropriate and "the generally accepted way of calculating return on investment." J.A. 177.

The FTB also argues that while the three factors of property, payroll and sales are interdependent, Container is attacking the payroll factor independently of the others. Appellee's Br. at 102-03. The FTB cites *Norfolk and Western Railway Co. v. North Carolina*, 297 U.S. 682 (1936), for the proposition that a taxpayer cannot demonstrate the invalidity of a formula by attacking only one element of the formula. The short answer to the FTB's argument is that Container has not limited its attack to the payroll factor; all of Container's computations showing distortion take into account all three factors. Thus, *Norfolk and Western* is not applicable.

Finally, contrary to the FTB's assertion, all of the data pertaining to Container involve the years in suit except for the unit cost comparison, which involves the year 1974. Container's assistant controller testified, however,

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[17] *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952), cited by the FTB (Appellee's Br. 100), does not militate against the premise. There, a corporation operating within the United States incurred greater costs in California as a result of the introduction of a new product. In the present case the distortion occurs not as a result of such short-term differences but because of substantial economic differences between the United States and the countries in which the subsidiaries operate, especially in regard to payroll costs and rates of profitability.

that in his opinion the comparison for the year 1974 would be substantially the same, or even more favorable to Container, if the comparison could have been made for the years in suit. Stip. re Testimony, J.A. 115. Furthermore, the other figures presented by Container are all specifically for the years in suit, or closely related to those years, except where a comparison with more recent figures is deliberately made.

III. CALIFORNIA'S APPORTIONMENT VIOLATES THE COMMERCE CLAUSE BECAUSE IT RESULTS IN MULTIPLE TAXATION OF FOREIGN SOURCE INCOME

The FTB does not seriously dispute that, in the present case, multiple taxation of the same income occurs by California and the countries where the most profitable subsidiaries are located (Colombia, Venezuela, Holland and Mexico). The facts are as follows:

1. Each subsidiary filed income tax returns on a separate accounting basis with the country wherein the subsidiary operated. Stip. ¶ 140, J.A. 72.

2. The actual amounts of income taxes paid by the subsidiaries in Colombia, Venezuela, Holland and Mexico are set out in a table in the record. Stip. ¶ 159, J.A. 83-84. In only minor instances in Venezuela, and one instance in Mexico, does the table show a provision for taxes stated on Form 2952, rather than the actual taxes paid by the subsidiaries. The record states, however, that the provision for taxes is very close to the actual taxes paid. Stip. ¶ 160, J.A. 85.

3. The record contains the net income of the subsidiaries computed in accordance with generally accepted accounting principles. Stip. ¶ 160, J.A. 85. This net income was included in the Forms 2952 filed by Container with its federal income tax returns, and it is the net income which the FTB auditor used in combining the income of the subsidiaries with that of Container. Stip. ¶ 21, J.A. 11. As a

consequence, the record contains the book net income of the subsidiaries which was used to compute the California tax, the California franchise tax paid on that income and, with minor exceptions, the actual net income taxes paid by the Colombian, Venezuelan, Dutch and Mexican subsidiaries to their governments.[18] There can be no question, therefore, that the net income of the subsidiaries was taxed once by the foreign countries involved and again by California. The FTB does not rebut the above,[19] but simply reiterates that California is only taxing Container and not the foreign subsidiaries, conveniently ignoring the undisputed evidence of multiple taxation.

The FTB's efforts to limit the Court's decision in *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), to property taxes on containers is unavailing. *Japan Line's* holding that state taxation in the area of foreign commerce raises the additional issues of multiple taxation as between the state and foreign governments and of impairment by the state of federal policy is certainly not limited to property taxes. In this regard see the *amicus* memorandum filed for the United States in *Chicago Bridge and Iron Company v. Caterpillar Tractor Co.*, No. 81-349, set forth in pertinent part in Appendix F to Appellant's Brief on the Merits.

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[18] A simple comparison of taxes paid by the subsidiaries to their book net income demonstrates that substantial taxes were paid on that income for the years in question. Compare Stip. ¶ 159, J.A. 84 with Exhibits A-1 to A-6, J.A. Exhib. 1-6.

[19] Because the record in the main shows actual taxes paid, rather than a provision for taxes, the unfounded attack by the MTC and other *amici* supporting the FTB on the provision for taxes of the Italian subsidiaries is unimportant. (MTC Br. 7, 21 n. 35.) In any event, the MTC erroneously offsets the losses of some subsidiaries against the profits of others, thereby showing that the Italian subsidiaries *as a group* had an average net income of only $34,000 for the years, whereas the average tax provision was over $121,000. The MTC overlooks the fact, *inter alia*, that under the Italian net income tax law the losses of one corporation cannot be offset against the profits of another. *See* Harvard University, *World Tax Series—Taxation in Italy* 335, 423-24 (1964).

The Court's decision in *Mobil Oil Corp. v. Commissioner of Taxes*, 455 U.S. 425 (1980), does not bar the application of *Japan Line* to this case. *Mobil* did not involve worldwide unitary combination where a conflict between taxation of income by a state and foreign governments is a major issue. *Mobil* involved a conflict in taxation of dividends as between the states; a conflict between the State of Vermont and foreign governments was not involved.

In a confusing argument the FTB appears to concede that some of the same income is being taxed twice, once when apportioned to California as income of Container and once by the foreign countries which tax the subsidiaries on a separate accounting basis. Appellee's Br. at 116-18. However, the FTB equates taxation by the federal government and the states of the same income of a United States corporation with the taxation by California and foreign countries of the same income of foreign subsidiaries of a United States parent. Those foreign countries are not members of a federal system with California wherein both governments are supplying governmental services to a taxpayer. Moreover, while the same dollar of income could be "earned" in both California and the United States, thereby justifying taxation by both jurisdictions, the same dollar of income cannot have been earned in both California and Colombia. Thus, California is not entitled to tax subsidiary income which is earned in a foreign country and taxed by the foreign government.[20]

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[20]The FTB's reliance upon the foreign tax credit against Container's federal income tax is misplaced. I.R.C. § 901. The foreign tax credit only helps to prevent multiple taxation where the federal government is taxing income also subject to tax by a foreign government. Since the federal government does not tax the undistributed income of foreign subsidiaries of U.S. parents (except for Subpart F, Sections 951-964, I.R.C., which does not apply to Container's operating subsidiaries), no foreign tax credit would be available for the type of multiple taxation being imposed in this case. Furthermore, the foreign tax credit applies only to the federal income tax. California does not provide such a credit.

CONCLUSION

Container submits that the issues in this case are clearly resolved by application of leading decisions of this Court. *ASARCO* and *Woolworth* require a holding that Container and its foreign subsidiaries are not unitary because of the lack of substantial operational interdependence. *Hans Rees'* and *Norfolk & Western Railway v. Missouri* compel a decision that worldwide unitary combination violates the due process clause because of the resulting state taxation of extraterritorial income, and *Japan Line* similarly requires a holding that such combination violates the commerce clause because of the resulting double taxation and impairment of the ability of the federal government to speak with one voice in regard to foreign policy.

For the foregoing reasons, Container submits that the decision of the California Court of Appeal should be reversed.

Dated: December 23, 1982.

Respectfully submitted,

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APPENDIX A

Restatement of Chart, Appellant's Brief on the Merits page 17, based on taxable separate accounting income for Container and book separate accounting income for the subsidiaries.

1963 - 1965
(000's omitted)

		Average Pre-Tax Income Per Arm's Length in Different Countries	Average Pre-Tax Income per Worldwide Apportionment
1.	Container (United States)	$31,549	$34,704
2.	Colombia	4,253	2,383
3.	Mexico	1,605	1,547
4.	Venezuela	4,246	2,064
5.	Panama	1,286	0
6.	Austria	(13)	12
7.	Germany	1,793	3,145
8.	Holland	384	214
9.	Italy	34	1,069
10.	Total Foreign	13,588	10,433*
11.	Total Combined	45,137	45,137

* Rounding-off of numbers in multiplication causes slight discrepancy from addition of the column.

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

BRIEF *AMICI CURIAE*

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QUESTIONS PRESENTED

1. Whether the application of California's franchise tax to include income of foreign corporations in a worldwide combined report creates a substantial risk of international multiple taxation in violation of the commerce clause of Article 1, Section 8 of the Constitution of the United States.

2. Whether the application of California's franchise tax on a worldwide combined basis is fundamentally flawed and does not produce a rational relationship between the income attributed to California and California values, in violation of the due process clause of the fourteenth amendment to the Constitution of the United States.

3. Whether the Constitutional infirmities of worldwide combined reporting are far more serious when the method is applied to foreign parent groups.

TABLE OF CONTENTS

	Page
INTEREST OF *AMICI CURIAE*	2
SUMMARY OF ARGUMENT	3
ARGUMENT	4
I. Application of California's Franchise Tax to Include Income of Foreign Corporations in a Worldwide Combined Report Violates the Commerce Clause by Creating a Substantial Risk of International Multiple Taxation	4
II. Application of California's Franchise Tax on a Worldwide Combined Basis is Fundamentally Flawed and Does Not Produce a Rational Relationship between the Income Attributed to California and California Values, in Violation of the Due Process Clause of the Fourteenth Amendment	6
III. The Constitutional Infirmities of Worldwide Combined Reporting are Far More Serious when the Method is Applied to Foreign Parent Groups	14
CONCLUSION	15

TABLE OF AUTHORITIES

CASES: Page

ASARCO Inc. v. *Idaho State Tax Comm'n*, ___ U.S. ___, 50 U.S.L.W. 4962 (1982) 7, 10

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U.S. 271 (1924) 8, 10

Butler Brothers v. *McColgan*, 315 U.S. 501 (1942) 9

Chicago Bridge & Iron Company v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, prob. juris. noted, ___ U.S. ___, No. 81-349 (Oct. Term, 1982) 2, 4, 6

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) 6, 7, 8, 9, 13

Fargo v. *Hart*, 193 U.S. 490 (1904) 10

F. W. Woolworth Co. v. *Taxation and Rev. Dep't of New Mexico*, ___ U.S. ___, 50 U.S.L.W. 4957 (1982) 7, 10

Hans Rees' Sons v. *North Carolina*, 283 U.S. 123 (1931) 8

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 3, 4

Mobil Oil Corp. v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) 6, 7, 9, 10

Moorman Manufacturing Co. v. *Bair*, 437 U.S. 267 (1978) ..... 8 ,9

Nashville C. & St. L.R. Co. v. *Browning*, 310 U.S. 362 (1940) 8

National Bellas Hess, Inc. v. *Department of Revenue*, 386 U.S. 753 (1967) 6

Norfolk & Western R. Co. v. *State Tax Commission*, 390 U.S. 317 (1968) 6, 8, 10

Northwestern States Portland Cement Co. v. *Minnesota*, 358 U.S. 450 (1959) 9

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 8, 15

Wisconsin v. *J. C. Penny Co.*, 311 U.S. 435 (1940) ... 6

CONSTITUTION OF THE UNITED STATES:

Commerce Clause, Art. 1, § 8 ..... 3, 4, 5, 15

Due Process Clause, Fourteenth Amendment .. 3, *passim*

Table of Authorities Continued

Page

MISCELLANEOUS:

"Hourly Compensation Costs for Production Workers in Manufacturing," United States Department of Labor, Bureau of Labor Statistics (April 1982) . 12, 13

Note from the European Economic Community to the United States Department of State, June 29, 1982 3

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 81-523

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

BRIEF *AMICI CURIAE*

Allied Lyons p.l.c., Barclays Bank p.l.c., B.A.T Industries p.l.c., The B.O.C. Group, The Bowater Corporation p.l.c., Cadbury Schweppes p.l.c., The Charterhouse Group p.l.c., Chloride Group Limited, Foseco Minsep Limited, Imperial Chemical Industries p.l.c., Imperial Group p.l.c., Lloyds Bank p.l.c., Midland Bank p.l.c., National Westminster Bank Limited, Reckitt & Colman p.l.c., Reed International Limited, Sears Holdings Limited, Unilever p.l.c., and Unitary Tax Campaign Limited hereby submit this brief *amici curiae* in support of the appeal by Container Corporation of America ("Container") from a judgment of the Court of Appeal of the State of California for the First Appellate District, upholding the validity of the California franchise tax as construed to require worldwide combined reporting.[1]

[1] Appellant and Appellee have consented to the filing of this brief *amici curiae* in letters filed with the Clerk of the Court.

INTEREST OF *AMICI CURIAE*

The individual *amici curiae* ("*amici*") are parent corporations organized and existing under the laws of England. Together with their worldwide subsidiaries, they rank among the largest industrial and financial enterprises in the world. *Amici* have no permanent establishments in the United States and do not conduct business in the United States. However, they have subsidiary corporations which conduct business throughout the world, including United States subsidiaries with extensive business operations in the United States.

Amicus Unitary Tax Campaign Limited is an organization formed by more than 50 leading United Kingdom parent corporations for the express purpose of combatting worldwide combined reporting.

Amici have a direct and vital interest in opposing any attempt to impose formulary apportionment upon foreign corporations through worldwide combined reporting. By applying that method to the United States subsidiaries of foreign parent corporations, certain states of the United States reach, and tax, income which is earned by the foreign parents and their non-United States subsidiaries in their foreign operations and which is fully taxed abroad. The strength of the concern and resolve of *amici* in this matter is evidenced by their filing of a brief *amici curiae* in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, prob. juris. noted, ___ U.S. ___, No. 81-349 (Oct. Term, 1982) ("*Chicago Bridge & Iron Company*"). Although both *Chicago Bridge & Iron Company* and the present case involve constitutional challenges to worldwide combination by United States parent corporations with foreign subsidiaries, the interests of *amici* may be significantly affected by the decisions of the Court in these cases.

The concerns expressed here by *amici* are but a small reflection of the unabated frustration and anger among foreign parent corporations and sovereign governments engendered by the worldwide combined reporting method. In the most recent expression of concern, on June 29, 1982 the Government of

Belgium, which now holds the presidency of the European Community, served a Note upon the United States Department of State reiterating the firm opposition of the ten member nations to this method of taxation:

> "Our Governments remain firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory."

Foreign parent corporations have an even greater stake in this matter than do United States parent corporations. While for both United States and foreign parents the method suffers from the same fundamental flaw which produces a misattribution of foreign income to the states which employ it and thereby creates a substantial risk of multiple taxation, the constitutional infirmities are far more serious when the method is applied to foreign parent corporations. Accordingly, *amici* deem it essential that the Court consider their perspective in reaching its decision.

SUMMARY OF ARGUMENT

California's attempt to expand the unitary business principle to require worldwide combination of foreign corporations affiliated with a United States corporation violates the commerce clause and the due process clause. First, by including in the combination income of foreign corporations which is fully taxed in foreign countries, the method creates a substantial risk of international multiple taxation, in violation of the first principle applicable to state taxation of foreign commerce enunciated in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). The facts of this case amply demonstrate that international multiple taxation is not only a substantial risk but a reality. Second, California's attempt to apply formulary apportionment on a worldwide basis is fundamentally flawed and constitutes taxation under a pretense. The requisite rational relationship between the income attributed to California and California values does not exist because the economies of foreign countries are not homogeneous with that of the

United States. Worldwide formulary apportionment is inherently arbitrary and produces such misattribution of foreign income to California as to violate due process. Finally, the constitutional infirmities of worldwide combined reporting are far more serious when the method is applied to foreign parent groups than when applied to United States parent groups.

ARGUMENT

I. Application of California's Franchise Tax to Include Income of Foreign Corporations in a Worldwide Combined Report Violates the Commerce Clause by Creating a Substantial Risk of International Multiple Taxation.

This Court has held that a state tax upon foreign commerce which "notwithstanding apportionment, creates a substantial risk of international multiple taxation," is unconstitutional under the commerce clause.[2] *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979) ("*Japan Line*"). "Even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 456. The reason for this special constitutional stricture is that in foreign commerce "true apportionment does not exist and cannot be policed by this Court at all." *Id.* at 455.

In their brief in *Chicago Bridge & Iron Company amici* maintain that by requiring income of foreign corporations

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[2] *Amici* respectfully submit that California's tax also contravenes the commerce clause by intruding upon federal prerogatives and preventing the United States from speaking with one voice in regulating the conduct of international commercial relations. California's worldwide apportionment method is irreconcilably at odds with the arm's length international separate accounting principle established by treaty and the Internal Revenue Code for federal income tax purposes. This contention is presented in their brief *amici curiae* in *Chicago Bridge & Iron Company*.

which is fully taxed abroad and not subject to federal tax to be included in the state tax base, the worldwide combined reporting method inexorably creates a substantial risk of international multiple taxation. Unless the apportionment factors applied to the worldwide income base eliminate the foreign income, there will be a resulting misattribution of such income to the taxing state; multiple taxation will occur whenever the foreign corporation is more profitable in relation to its apportionment factors than is the United States affiliate with which it is combined. *Amici* respectfully request the Court to give full consideration to the commerce clause arguments set forth in that brief in connection with this case, for the multiple tax risk and the resulting discrimination against foreign commerce is the primary constitutional defect of worldwide combination.

The record in the instant case amply demonstrates that international multiple taxation is not only a substantial risk but a reality. Container has established that the income of its foreign subsidiaries, determined on the basis of the internationally accepted arm's length separate accounting standard, was fully taxed for the years in question in the foreign countries in which those subsidiaries operate.[3] Container has likewise shown that the application of California's worldwide apportionment, if sustained, would result in the attribution to California of large amounts of the fully taxed foreign income of those subsidiaries, and consequently that California would also levy a tax on that foreign income. Specifically, for the years in question California attempts to tax over $1,200,000 of income that was also taxed by the domiciles of Container's foreign subsidiaries.[4] Such international double taxation is unconstitutional under the commerce clause.

The risk of international multiple taxation would be present even if formulary apportionment on a worldwide basis were

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[3] (J.A., Stip. ¶ 140 and Exhibit A thereto). All references to "J.A." are to the separately bound Joint Appendix.

[4] (J.A., Exhibit A to Stip.).

not fundamentally flawed. As *amici* discuss below in connection with the due process clause, a flaw exists which greatly increases that risk.

II. Application of California's Franchise Tax on a Worldwide Combined Basis is Fundamentally Flawed and Does Not Produce a Rational Relationship between the Income Attributed to California and California Values, in Violation of the Due Process Clause of the Fourteenth Amendment.

The due process clause of the fourteenth amendment to the Constitution imposes two requirements on a state before it can levy a tax on income generated in interstate commerce: "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207, 219-20 (1980) ("*Exxon*"), quoting *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980) ("*Mobil*"); *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967); *Norfolk & Western R. Co.* v. *State Tax Commission*, 390 U.S. 317 (1968) ("*Norfolk & Western*").

As a threshold principle, a state has nexus to tax a corporation "if the corporation avails itself of the 'substantial privilege of carrying on business within the State.' " *Mobil*, 445 U.S. at 437, quoting *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435, 444-45 (1940). California obviously has the requisite nexus to tax Container.[5]

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[5] The Court has not yet considered whether state nexus as to one corporation is sufficient to permit the state to ignore separate corporate existence and to require affiliated United States or foreign corporations conducting a unitary business with it to be included in a combined report. This issue has been raised and briefed by the appellant in *Chicago Bridge & Iron Company*.

In order for a state to tax a corporation engaged in interstate commerce on an *apportioned* basis, however, there must be a close functional relationship between the in-state activities and the income from interstate commerce which the state attempts to tax. "The 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary business principle.' " *Exxon*, 447 U.S. at 223, quoting *Mobil*, 445 U.S. at 439. Thus, the Court has recently held that a non-domiciliary state whose only contact with a corporation is the conduct of a unitary business within and without the state may tax a fair share of the income generated by the business, regardless of the geographic source of the income (*Exxon* and *Mobil*), but it may not tax income which is not derived from the unitary business operation. *ASARCO Inc.* v. *Idaho State Tax Comm'n.*, ____ U.S. ____, 50 U.S.L.W. 4962 (1982) ("*ASARCO*"); *F.W. Woolworth Co.* v. *Taxation and Rev. Dept. of New Mexico*, ____ U.S. ____, 50 U.S.L.W. 4957 (1982) ("*Woolworth*"). Accordingly, if Container is found not to be unitary with its foreign subsidiaries, worldwide combination would be prohibited by the "linchpin" standard.[6]

However, establishing the existence of a unitary business does not end the due process analysis, but merely lays the necessary foundation for the taxation of a reasonable share of income by a state in which that business is conducted. It is then necessary under the second prong of the due process test to consider whether the method used by the state to determine its share of that income is calculated to, and does in fact, produce a fair result.

"It is fundamental that a State has no power to impose a tax on income earned outside of the State." *Mobil*, 445 U.S. at 451 (Mr. Justice Stevens, dissenting). The due process clause pro-

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[6] *Amici* express no view as to whether Container and its subsidiaries are engaged in a unitary business.

hibits extraterritorial taxation whether such taxation results from apportionment or otherwise:

> "A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.' *Nashville C. & St. L.R. Co.* v. *Browning*, 310 U.S. 362, 365 (1940). Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State."

Norfolk & Western, 390 U.S. at 325.

Due process does not require state income to be computed with mathematical precision, but only so as to obtain a "rough approximation" of the income that is "reasonably related to the activities conducted within the taxing state." *Exxon*, 447 U.S. at 223; *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267, 273 (1978) ("*Moorman*"). However, a state tax which is "out of all appropriate proportion to the business transacted by the appellant in that state" will not satisfy the requirement of a rational relationship. *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123, 135 (1931). In such a case the income attributed to the state is "in no just sense attributable to transactions within" the state. *Id.* at 134. "[N]either does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product." *Norfolk & Western*, 390 U.S. at 327. A method of apportionment which is "inherently arbitrary" or which can be shown to have "produced an unreasonable result," will not satisfy due process. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920). Such a method will be correctly perceived by the Court as "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271, 283 (1924) ("*Bass, Ratcliff*").

For corporations operating in *interstate* commerce, it has long been established that the income approximations may be derived from formulas that rationally apportion the entire net

income of the unitary business conducted by the corporation. *Exxon*, 447 U.S. at 219; *Mobil*, 445 U.S.at 436; *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959). Moreover, the Court has afforded the states wide latitude in the factors to be included in the formulary apportionment. *Moorman*. Nonetheless, states are not free under the due process clause to impose an irrational apportionment.

Formulary apportionment was originated and nurtured in the United States as a rough but expedient method of dividing the total profits of a corporation engaged in a unitary business among the various states in which it operates. The three-factor formula employed by California has been generally accepted as a fair method of achieving this division, and its widespread use among the states has been motivated by a desire for uniformity.

Formulary apportionment is predicated upon the rational premise that one dollar of property, payroll or sales expended in one state will generate roughly the same amount of income as one dollar expended comparably in another state. The Court has implicitly acknowledged this premise in *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942), as follows:

> "We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors may properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business." *Id.* at 509.

When the formula is applied to operations within the United States, where productivity, wage rates, costs of capital, gross profit margins, and returns on similar investments are reasonably homogeneous, and the currency is the same, it will result in attributing to each state in which the corporation operates at least a "rough approximation" of the income related to its activities in that state, as required by the due process clause. *Amici* are familiar with the application of this method to appor-

tion the income of their United States subsidiaries among the states in which they operate and take no exception to it.

However, a small number of states, led by California, have attempted to apply formulary apportionment on a worldwide basis.[7] *Amici* submit that this attempt must fail, for the rational relationship mandated by the due process clause is lacking. While apportionment "may produce a tolerable product" in a United States domestic setting, when applied internationally it produces an inherently distorted result which cannot satisfy even the broad latitude of a "rough approximation." The Court noted an analogous problem regarding the apportionment of railroad rolling stock for property tax purposes in *Norfolk & Western*, 390 U.S. at 329 (quoting Mr. Justice Holmes' statement in *Fargo* v. *Hart*, 193 U.S. 490, 499-500 (1904)):

> "So long as it fairly may be assumed that the different parts of a line are about equal in value a division by mileage is justifiable. But it is recognized in the cases that if for instance a railroad company had terminals in one state

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[7] The Court has not yet considered the validity of formulary apportionment of the income of foreign corporations not operating in the United States. State income tax apportionment of foreign source income has been challenged on due process grounds in four cases—*Bass, Ratcliff; Mobil; ASARCO;* and *Woolworth*. *Bass, Ratcliff* involved a single foreign corporation operating in the United States and England. In that case the taxpayer made no showing that the apportionment applied by New York resulted in a misattribution of foreign income and, in any event, the amount of tax in question, $826.14, was de minimis. While this Court's decision in *Mobil* implies that foreign income may not enjoy an absolute immunity from a fair apportionment under the due process clause, Mobil had "disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula." *Mobil*, 445 U.S. at 434. The inherent unfairness of the apportionment of worldwide income under California's combined reporting method is precisely the issue presented by the instant case. Finally, in *ASARCO* and *Woolworth* the Court did not reach the issue of the propriety of the state apportionment of dividends because the foreign subsidiaries were found not to be unitary with their United States parents.

> equal in value to all the rest of the line through another, the latter State could not make use of the unity of the road to equalize the value of every mile. That would be taxing property outside of the State under a pretense."

The situation with worldwide combined reporting is even more serious. There cannot be even a pretense that worldwide formulary apportionment properly reflects relative values and produces an appropriate result in the "usual" case. Distortions will not be confined to exceptional situations but must be the anticipated result of applying this method to widely disparate economies.

Apportionment on a worldwide combined basis is fundamentally flawed. In a multinational context, the assumption of comparable economic conditions that underlies the rationality of formulary apportionment in the United States is simply not valid. Worldwide economic conditions are much more diverse than conditions within the United States. There are wide ranges in wage rates and productivity of labor in different areas of the world; the costs of property and equipment vary substantially; accounting methods and currencies are different; conversion rates fluctuate; and rates of return on investment vary widely. An apportionment of total worldwide income that does not account for these differences cannot rationally approximate the fair share of business income generated by worldwide activities that relates to the corporate activities conducted within a particular state.

The record in this case includes testimony showing that the rates of return on investment in many foreign countries are expected to be, and are in fact, substantially higher than in the United States. Particularly in developing countries, political and commercial risks require companies to realize higher rates of return on operations than are realized on United States investments. Lower foreign wage rates and property values and larger gross profit margins account for these higher returns and create an inherent bias in formulary apportionment in favor of the states which require worldwide combination.

International disparities in wage rates are broad, and the United States tends to have higher rates.[8] These disparities have a compounded distorting effect in the three-factor apportionment formula. First, lower labor costs abroad tend to increase the net profit included in the worldwide income base which is apportioned by the three-factor formula. Second, the relatively higher United States costs produce a payroll factor which is biased towards the United States. The product of worldwide combination is a *reversal* of the true profit allocations. Manifestly, this is taxation of income "under a pretense" of worldwide factor comparability which simply does not exist.

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[8] In addition to comparable studies which *amici* understand will be cited in Appellant's brief, the broad pay rate disparities around the world are illustrated by the results of a study completed in April 1982 by the United States Department of Labor, Bureau of Labor Statistics, entitled "Hourly Compensation Costs for Production Workers in Manufacturing." The study compares hourly compensation costs for production workers in manufacturing industries in selected countries. While a few of the major industrialized countries show costs comparable to or in excess of the United States index, most are lower, and the results for developing countries are uniformly and substantially lower. The following table, drawn from that study, shows comparative hourly compensation for various countries using an index of 100 for the United States:

	1978	*1979*	*1980 (Preliminary Estimates)*	*1981 (Provisional Estimates)*
United States	100	100	100	100
Canada	93	90	90	89
Brazil	20	19	17	19
Mexico	24	26	30	33
Venezuela	30	30	39	—
Australia	73	71	73	73
Hong Kong	14	14	13	13
Israel	31	36	38	39
Japan	67	60	56	56
Korea	10	13	11	11
New Zealand	48	50	50	49
Singapore	11	12	12	—
Taiwan	10	11	13	14
Austria	75	79	79	63

The record in this case demonstrates the distorting effect of worldwide formulary apportionment. During the years involved (1963-1965), the average rate of return on operations of Container's foreign subsidiaries was 17.2%, while Container's rate of return from United States operations was 13.1%. Each dollar of net operating profit of the foreign subsidiaries required $7.05 of sales, $4.62 of tangible property and $1.05 of payroll. Over the same period, each dollar of net operating profit of Container's United States operations required $10.65 of sales, $4.83 of tangible property and $3.34 of payroll.[9] By including the income derived from the more profitable operations of the foreign subsidiaries in the base to be apportioned and mechanically applying the apportionment formula on a worldwide basis, the Franchise Tax Board was able to generate over $1,200,000 in additional California income.

Container has gone far beyond the efforts to show extraterritorial taxation based upon internal separate accounting which the Court found wanting in *Exxon*. It has demonstrated

	1978	*1979*	*1980 (Preliminary Estimates)*	*1981 (Provisional Estimates)*
Belgium	125	132	132	101
Denmark	106	111	104	82
Finland	69	81	82	74
France	79	87	92	75
Germany	116	124	123	95
Greece	28	31	31	28
Ireland	48	54	60	50
Italy	73	79	83	69
Luxembourg	118	121	118	—
Netherlands	120	126	122	93
Norway	114	111	113	95
Portugal	20	19	20	—
Spain	46	59	59	51
Sweden	116	125	125	107
Switzerland	116	117	112	91
Turkey	13	12	—	—
United Kingdom	52	61	74	67

[9] (Statistics derived from Sch. VI and Exhibit A to Stip., J.A.).

by "clear and cogent evidence": (1) the true profits of its foreign subsidiaries, (2) the inherent bias in worldwide combined reporting towards misallocation of foreign income to the United States, and (3) the precise manner in which that bias produces a distorted result in this case. Due process does not permit California to tax the foreign income which it claims here.

III. The Constitutional Infirmities of Worldwide Combined Reporting are Far More Serious when the Method is Applied to Foreign Parent Groups.

As this case amply demonstrates, combined reporting may not be constitutionally applied to foreign members of *any* corporate group. Nevertheless, application of the method to foreign parent corporations and their foreign affiliates raises serious concerns beyond those applicable to United States parent groups. The inherent bias of worldwide combined reporting creates even more unconscionable results in that situation. In the case of United States parent corporations, the distortion may produce a tax on foreign income which has not been repatriated through dividends. In the case of a United States subsidiary of a foreign parent, the foreign income reached by this method not only has no current relationship to United States operations but is not even under the control of the United States subsidiary whose nexus with the state provides the basis for taxation.

Worldwide combined reporting also imposes extraordinary and often impossible compliance burdens upon foreign parent groups. The method presumes a ready availability of financial records based upon United States tax principles. For United States parent groups, this may be a reasonable assumption. Few, if any, foreign parent corporations maintain financial accounting records in that form, but quite naturally adhere to the particular financial accounting requirements of their home countries. In many instances the task of converting to suit the state tax authorities is simply impossible. In others, foreign secrecy laws preclude disclosure of the information to state tax authorities. Faced with these practical difficulties, such au-

thorities frequently resort to estimates and approximations of both the apportionment factors and the income to be apportioned. The burden is vastly increased by the fact that foreign currencies must be translated into dollars in order to compute the income and apportionment factors. As *amici* state in their brief in *Chicago Bridge & Iron Company*, these are not merely problems of inconvenience. The rational relationship is lacking because the method simply *cannot* be applied properly to foreign parent groups.

Further, the unique status of foreign parent corporations under income tax treaties and treaties of friendship, commerce and navigation, coupled with the natural solicitude of foreign nations towards protecting their domiciliaries from excessive tax intrusions by the states of the United States, affords them an international legal status which is different from that of foreign subsidiaries of United States parent corporations.

CONCLUSION

Container has exposed worldwide combination for what it is—taxation "under a pretense"—"an effort to reach profits earned elsewhere under the guise of legitimate taxation." Even if the method did not have a fundamental flaw resulting in an inherent bias in favor of the taxing state, the substantial risk of international multiple taxation which necessarily arises from the apportionment of foreign income of foreign corporations violates the commerce clause. A "reasonable approximation," even if achievable, will not suffice in the international arena where "even a slight overlapping of tax" risks multiple taxation. The inherent bias demonstrated by the record in this case both exacerbates that risk and destroys the pretense that the worldwide combined reporting method has "reached, and was meant to reach, only the profits earned within the state." *Underwood Typewriter Co.* v. *Chamberlain*, *supra*, 254 U.S. at 121. Therefore, it fails to satisfy the requirements of due process as well.

For these reasons, the decision of the court below should be reversed. Should the Court find in this case that the application

of worldwide combined reporting to a United States parent corporation does not violate constitutional principles, *amici* ask that the Court expressly limit its opinion so as not to foreclose foreign parent corporations from demonstrating the constitutional infirmities of this method of taxation in other cases.

Respectfully submitted,

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CONTAINER CORPORATION OF AMERICA,

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ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

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TOPICAL INDEX

Page

Table of Authorities iii

Interest of Amici 1

Summary of Argument 2

Argument

I.

The California Worldwide Unitary Combined Tax Reporting Method Contravenes The Due Process Clause By Imposing An Extraterritorial Tax Without Nexus To California And Without Explicit Statutory Authority 3

II.

Worldwide Unitary Combined Tax Reporting Imposes Unconstitutional International Multiple Taxation 7

III.

The California Worldwide Unitary Combined Tax Reporting Method, As Applied, Violates The Due Process and Equal Protection Clauses Of The Fourteenth Amendment To The United States Constitution And Burdens Foreign Commerce 11

Conclusion 15

TABLE OF AUTHORITIES CITED

Cases	Page
Alcan Aluminum Ltd. v. Franchise Tax Bd., 81 Civ. 3911 (GLG) (S.D.N.Y. filed Dec. 3, 1981)	7, 8
Alcan Aluminum Corp. v. Franchise Tax Bd., C196604 (Los Angeles County Super. Ct. filed April 15, 1977)	8
Anaconda v. Franchise Tax Bd., No. 1-48666 Cal. Ct. App. filed Mar. 24, 1982	7
ASARCO Inc. v. Idaho State Tax Commission, 50 U.S.L.W. 4962 (U.S. June 29, 1982)	6, 9
Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924)	6
Capitol Industries - EMI, Inc. v. Bennett, No. 80-4114 (9th Cir. 1982), *remand pending*	8
Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 117 N.E.2d 1343 (1981)	7
Burnett v. Brooks, 288 U.S. 378 (1933)	4
Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., _____ U.S. _____, 102 S. Ct. 564 (1981), No. 81-349, October Term, 1981 (Sept. 14, 1981)	2, 7, 8, 9, 15
Container Corp. of America v. Franchise Tax Bd., 117 Cal.App. 3d 988, 173 Cal.Rptr. 121 (1981), *appeal docketed*, _____ U.S. _____, No. 81-523, October Term, 1981	5, 15
Edison California Stores v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947)	5
F.S. Royster Guano Co. v. Virginia, 253 U.S. 412 (1920)	12
Firestone Tire & Rubber Co. v. Franchise Tax Bd., No. 2-62918 (Cal. Ct. App. filed 1981)	7
Foley Bros. v. Filardo, 336 U.S. 281 (1949)	6
Hans Rees' Sons v. North Carolina, 283 U.S. 123 (1931)	12, 14

Home Telephone & Telegraph Co. v. City of Los Angeles, 277 U.S. 278 (1913) 11
International Harvester Co. v. Evatt, Tax Commissioner, 329 U.S. 416 (1947) 13
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 8, 9, 14
Kansas v. Colorado, 206 U.S. 46 (1906) 6
Max Factor & Co. v. Franchise Tax Bd., 35 Cal.App. 3d 7, 110 Cal.Rptr. 536 (1973) 5
Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954) 3
Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980) 3, 9, 11
Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) 13
National Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753 (1967) 3
Norfolk & Western Railway Co. v. North Carolina, 297 U.S. 682 (1936) 12, 14
Raymond v. Chicago Union Traction Co., 207 U.S. 207 (1907) 11
Shell Petroleum N.V. v. Franchise Tax Bd., No. C 81-4302 MHP (N.D. Cal. filed Nov. 4, 1981) 7
Sioux City Bridge Co. v. Dakota County, 260 U.S. 441 (1922) 11
St. Louis v. The Ferry Co., 78 U.S. (11 Wall.) 192 (1871) 4
Union Pacific Railway v. Cheyenne, 113 U.S. 516 (1884) 9

United States Constitution

Article I, Section 8, Clause 3 (Commerce Clause) 2
Fourteenth Amendment, Section 1 (Equal Protection & Due Process Clauses) 2, 3, 4, 6, 11

Statutes

Cal. Rev. & Tax Code (West 1979)
§ 23040 5
§ 23057 10
§ 24345(a)(2) 10
§ 25102 ..... 5, 6
§ 25104 ..... 5, 6
§§ 25120-40 4
§ 25129 5
§ 25132 5
§ 25134 5
Internal Revenue Code § 1504(d) (CCH 1982) 7
Uniform Division of Income for Tax Purposes Act (UDITPA) 7A Uniform Laws Annotated 91, *et seq.* 4

Miscellaneous

Cal. Rev. & Tax Code Regulation § 25137(m) 12
California UDITPA Apportionment Manual ¶ 0300 (1977) 9
General Accounting Office, *Report to the Chairman, House Committee on Ways and Means, Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, July 1, 1982 ..... 10, 12
J. Hellerstein, *Allocation and Apportionment Of Dividends and the Delineation of the Unitary Business*, 14 Tax Notes 155 (1982) 13, 14
L. Henkin, *Foreign Affairs And The Constitution* (1972) 9
Organization for Economic Cooperation and Development Fiscal Affairs Committee, *Report, Transfer Pricing and Multinational Enterprises* (1979) 12
Restatement (Second) of Foreign Relations Law of the United States § 38 (1965) 6

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Ways and Means Comm., 96th Cong. 2d Sess. (March 31, 1980) (Statement of Assistant Treasury Secretary Donald C. Lubick) 12

Tax Treaties with the United Kingdom, The Republic of Korea and the Republic of the Philippines: Hearings Before The Senate Foreign Relations Comm. on Tax Treaties, 95th Cong., 1st Sess. 20-21 (July 19, 20, 1977) (Statement of Assistant Treasury Secretary Laurence N. Woodworth) 8

Transcript of Oral Arguments Before Supreme Court of the United States, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., No. 81-349 (U.S. argued April 19, 1982) 9

Uniform Division of Income for Tax Purposes Act (UDITPA), Commissioner's Note to § 11 (property factor) 7A *Uniform Laws Annotated* 102 (West 1978) 13

No. 81-523

In The

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

Brief of Jeffrey G. Balkin, James H. Sakoda and Derrick K. Takeuchi Amici Curiae in Support of Appellant

INTEREST OF THE AMICI CURIAE

The undersigned California attorneys, JEFFREY G. BALKIN, JAMES H. SAKODA and DERRICK K. TAKEUCHI, respectfully submit a Brief Amici Curiae in support of Appellant. Consent of the parties has been obtained from the Attorney General of the State of California and counsel for Container Corporation of America.

The respective law firms of which the undersigned are members have over the years represented taxpayers confronted with proposed unitary tax assessments. Said law firms are currently representing foreign-based multinational companies before state administrative agencies on proposed unitary tax assessments. Attorneys of the firms are Certified Tax Specialists of the State Bar of California who have had experience with practical and legal issues of state taxation in California. As a result of their state and federal practices, said attorneys have gained experience in the international context with the issues involved in this case and desire to contribute to the understanding of the Court on these issues with their far-reaching international ramifications.

A Brief Amici Curiae of the firms was previously submitted to the Court in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinois Dept. of Revenue, et al.*, No. 81-349, October Term, 1981, on which this Court heard oral arguments on April 19, 1982. The arguments briefed therein are equally applicable to the case at bar.

SUMMARY OF ARGUMENT

Container Corporation of America is a United States-based multinational. Hence, this case presents the issue, whether the application by California of a worldwide unitary combined income tax reporting method to United States-based multinationals conducting a unitary business violates the Equal Protection, Due Process and Commerce Clauses of the Constitution of the United States. The Court is not called upon to rule on the broader, more internationally sensitive issue of the legality of this taxing method in the context of a *foreign-based* unitary business. The Court is respectfully requested to expressly limit the scope of its ruling in this matter accordingly.

The California worldwide unitary combined tax reporting method does not meet constitutional standards enunciated by this Court because it attributes to California taxable income grossly disproportionate to activities conducted within the State; discriminates against foreign corporations with no constitutional nexus to California; creates an undue administrative burden for taxpayers in defending against assessments; causes material international double taxation; and unduly interferes with exclusive powers of the federal government over foreign commerce and relations.

Although the formula apportionment method which California applies has gained acceptance in the United States in the context of nationwide division of income of a unitary business, it has never been accepted internationally as an appropriate means for the division of income among countries.

ARGUMENT

I.

THE CALIFORNIA WORLDWIDE UNITARY COMBINED TAX REPORTING METHOD CONTRAVENES THE DUE PROCESS CLAUSE BY IMPOSING AN EXTRATERRITORIAL TAX WITHOUT NEXUS TO CALIFORNIA AND WITHOUT EXPLICIT STATUTORY AUTHORITY.

Under the Due Process Clause, a state may not impose a tax generated from interstate commerce unless it has a judicially well-recognized constitutional minimum connection with the taxpayer. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967); *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

In any exercise of its taxing power, a state must also possess proper jurisdiction to legislate the taxing statute. The Due Process Clause requires, in both the domestic and international contexts, that the limits of jurisdiction must not be transgressed through the mere inference of a taxing power by state revenue authorities from a statute which does not specifically so prescribe. *Cf. Burnet v. Brooks*, 288 U.S. 378, 401 (1933) (Due Process leaves limits of jurisdiction to be ascertained in each case with appropriate regard to distinct spheres of state and nation). Taxing a foreign entity or property without either the requisite statutory authority or nexus to the taxing state represents an unconstitutional attempt to extend a state's jurisdiction beyond the limits of due process. This Court established over a century ago that:

> Where there is jurisdiction neither as to person nor property, the imposition of a tax would be *ultra vires* and void. If the legislature of a State should enact that the citizens or property of another State or country should be taxed in the same manner as the persons and property within its own limits and subject to its own authority, or in any other manner whatsoever, such a law would be as much a nullity as if in conflict with the most explicit constitutional inhibition. *Jurisdiction is as necessary to valid legislative as to valid judicial action. St. Louis v. The Ferry Co.*, 78 U.S. (11 Wall.) 192, 194 (1871) (emphasis added).

Extraterritorial application of California's version of the Uniform Division of Income for Tax Purposes Act and the combined reporting provisions is now at issue before the Court in the case at bar.[1] Under the express pro-

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[1]Cal. Rev. & Tax Code § § 25120-40 (Stat. 1966, ch. 2 § 7)(West 1979) (Uniform Division of Income for Tax Purposes Act); Cal.

(footnote continued on following page)

visions of the California tax law, a taxpayer's foreign activities can be taken into account only to a limited extent in calculating franchise tax.[2] Although California apportions income, by reference to taxpayer's worldwide property, payroll and sales,[3] its revenue officials interpret California's tax law as allowing worldwide unitary combined tax reporting based in part on a constitutionally questionable principle, to wit: a multinational unitary business, consisting of separate corporate entities, organized and based in different countries, can be treated as one taxpayer.[4]

The partial operation of a worldwide multi-corporate unitary business within a taxing state does not, *ipso facto*, confer jurisdiction on that state to tax the entire worldwide multinational enterprise on an apportioned basis. In practical terms, the California tax statutes operate so that foreign corporations doing no business in California nevertheless have to report their income and apportionment data for determining the California tax.

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Rev. & Tax Code §§25102 (Stat. 1955, ch. 938, §20, *amended by* Stat. 1959, ch. 273, §3) & 25104 (Stat. 1955, ch. 938, §20) (West 1979) (Combined Reporting).

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[2]Cal. Rev. & Tax Code §23040 (Stat. 1949, ch. 557, § 1) (West 1979) defines *income* by reference to local activities carried on in foreign commerce.

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[3]Cal. Rev. & Tax Code §§25129 (Property Factor), 25132 (Payroll Factor) and 25134 (Sales Factor) (Stat. 1966, ch. 2, §37) (West 1979).

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[4]*Edison California Stores v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947); *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal.App. 3d 988, 994-95, 173 Cal.Rptr. 121 (1981), *appeal docketed*, _____ U.S. _____, No. 81-523, October Term, 1981 (September 14, 1981); *Max Factor & Co. v. Franchise Tax Bd.*, 35 Cal.App. 3d 7, 110 Cal.Rptr. 536 (1973).

Since most tax jurisdictions, including the United States, do not impose worldwide apportioned income taxes, the overseas affiliates' financial data must be specially developed for the Franchise Tax Board.

This Court recently indicated in *ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962, 4968 (U.S. June 29, 1982), that an attempt to tax extraterritorial income must be scrutinized to ascertain if it offends the Due Process Clause as "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation" *citing Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 283 (1924).

The tax provisions upon which California has relied over the years to impose international corporate tax combination are overdue for a rigorous due process examination. As part of this analysis, the Court is urged to strictly construe the California worldwide combined unitary tax reporting statute. "[R]ules of United States statutory law, whether prescribed by federal or state authority, apply only to conduct occurring within or having effect within, the territory of the United States, unless the contrary is clearly indicated." *Restatement (Second) of Foreign Relations Law of the United States* § 38 (1965). *See also Foley Bros. v. Filardo,* 336 U.S. 281, 285 (1949); *Kansas v. Colorado,* 206 U.S. 46, 68 (1906).

The pertinent combined reporting tax provisions, California Revenue & Taxation Code § § 25102 and 25104, do not specifically provide for combining foreign with domestic affiliates. The statutory authority of the Franchise Tax Board to apply combined reporting outside the United States cannot be merely inferred from the statute. Explicit statutory language, which does not currently exist, is necessary before California revenue authorities can tax

multi-corporate international activities.[5]

II.

WORLDWIDE UNITARY COMBINED TAX REPORTING IMPOSES UNCONSTITUTIONAL INTERNATIONAL MULTIPLE TAXATION.

A constitutional defect in California's franchise tax, as applied to such domestic-based multinationals as Container Corporation of America, Caterpillar Tractor Company and Chicago Bridge & Iron Company[6] *and* to such foreign-based multinationals as Shell Petroleum N.V.[7], Alcan Aluminum Limited[8] and EMI,

[5]An example of statutory language explicitly defining the authority to tax on an extraterritorial basis is the "contiguous country" exception to the general "water's edge" approach of federal combined return taxation in Internal Revenue Code §1504(d). This Code section defines the conditions under which a foreign corporation may be treated as a domestic corporation for federal tax purposes.

[6]*Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 117 N.E.2d 1343 (1981), *cert. granted sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ____ U.S. ____, 102 S.Ct. 564 (1981), No. 81-349, October Term, 1981 (September 14, 1981). Chicago Bridge & Iron Co. appealed in its posture as an intervenor and the record contains no facts regarding Chicago Bridge. Neither Caterpillar Tractor Co., the taxpayer, nor the Illinois Department of Revenue appealed the decision of the Illinois court. Chicago Bridge intervened as a plaintiff challenging the constitutionality of the Illinois system of worldwide combined unitary tax reporting.

[7]*Shell Petroleum N.V. v. Franchise Tax Bd.*, No. C 81-4302 MHP (N.D. Cal. filed Nov. 4, 1981) is pending in the United States District Court, Northern District of California.

[8]*Alcan Aluminum Ltd. v. Franchise Tax Bd.*, 81 Civ. 3911 (GLG) (S.D.N.Y. filed Dec. 3, 1981) in the United States District Court, Southern District of New York, has been stayed to await decision in the case at bar and *Anaconda v. Franchise Tax Bd.*, No. 1-48666 (Cal. Ct. App. filed March 24, 1982); *Firestone Tire &*

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Inc.[9] (all of whom are subject to worldwide combined reporting in California), is the inherent risk of international double taxation.

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450-51 (1979), the Court found the multiple tax unconstitutional in large part based upon two factors. First, Japan, taxpayer's commercial domicile, fully taxed the cargo containers in question without any apportionment. Thus, any tax by California over and above the Japanese tax constituted a multiple tax. Second, Japan's practice was not only justified under concepts of jurisdiction and international law, but it was the predominant practice among nations. The Court found that California's practice of taxing containers of a foreign shipper was a clear departure from the international norm.

In the case at bar, the State of California is similarly asserting a method of taxation, this time over multinational groups of companies, which is completely out of step with international practice.[10] The threat of retaliation and

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Rubber Co. v. Franchise Tax Bd., No. 2-62918 (Cal. Ct. App. filed 1981); *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ____ U.S. ____, No. 81-349, October Term, 1981 (September 14, 1981); and *Alcan Aluminum Corp. v. Franchise Tax Bd.*, C196604 (Los Angeles County Super. Ct. filed April 15, 1977).

[9] *Capitol Industries-EMI, Inc. v. Bennett*, No. 80-4114 (9th Cir. 1982) (*remand pending*, with order to dismiss the case of the U.S. subsidiary, Capitol Industries). The Ninth Circuit ruled on February 16, 1982 that California's system of worldwide combined unitary taxation does not provide a state remedy for foreign corporations to challenge assessments against their domestic subsidiaries.

[10] *See Tax Treaties with The United Kingdom, The Republic of Korea and The Republic of the Philippines: Hearings Before the Senate Foreign Relations Comm. on Tax Treaties*, 95th Cong., 1st Sess. 20-21 (July 19, 20, 1977) (Statement of Assistant Treasury Secretary Laurence N. Woodworth). Dr. Woodworth stated: "The

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multiple taxation under worldwide combined reporting is at least as serious, and at least as potentially disruptive to international commercial relations, as it was in the case of the multiple property tax on containers in *Japan Line*.[11] As this Court indicated in *Japan Line*, while a low level of double taxation in a purely interstate context is an acceptable price to pay for preserving state diversity, such is not the case where commercial relations with foreign nations are involved. In foreign commerce, "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S. at 456. *See also* L. Henkin, *Foreign Affairs And The Constitution*, 237 (1972).

(*footnote continued from previous page*)
Federal Government and virtually all the other governments in the world determine taxable income on the basis of what are arm's length transactions in dealings between related companies. This is the general rule. . . .I think the most serious problem in using the unitary system abroad is the fact that the arm's length rule is generally applicable in the world today. . . ."

[11] Admittedly, *Japan Line* involved property taxes, and therefore in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) the Court was unwilling to extend its multiple tax analysis in *Japan Line* to the Vermont tax. *See also Transcript of Oral Arguments Before Supreme Court of the United States* at 41 *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (____ U.S. ____, 102 S. Ct. 564 (1981), No. 81-349 (U.S. argued April 19, 1982). Nevertheless, it is appropriate to extrapolate from the *Japan Line* holding to this case since the California unitary concept which the Court describes in *ASARCO, Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. at 4965 as the "linchpin of apportionment" was itself derived from property tax law. California UDITPA Apportionment Manual ¶ 0300 (1977) states: "The 'unitary' business concept was derived from real property tax law, which applied what was known as the 'unit' rule. This rule was first approved in the case of *Union Pacific Ry. v. Cheyenne*, 113 U.S. 516 (1884)."

A constitutionally unacceptable double tax burden on international commerce results in significant part from California's practice of treating net income before foreign income taxes as the apportionable tax base for worldwide unitary combined tax reporting purposes.[12] (California, unlike most other taxing jurisdictions including the United States, does not provide income tax deferral for separately incorporated overseas operations.) To eliminate this virtual certainty of multiple taxation, California and other worldwide unitary combined tax reporting States[13] should be required by this Court, at a minimum, to compute tax on worldwide combined net income after allowance for foreign income taxes.[14]

[12]Cal. Rev. & Tax Code § 24345(a)(2) (Stat. 1955, ch. 938, § 20, amended by Stat. 1957, ch. 544, § 5) (West 1979) provides that nondeductible federal income taxes include foreign income taxes imposed at the national level.

[13]General Accounting Office (GAO), *Report to the Chairman, House Committee on Ways and Means, Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, 66, Appendix II, July 1, 1982. The GAO Report identifies those states which apply worldwide combined unitary tax reporting to corporations.

[14]This might require California to grant a provisional tax deduction or credit recapturable to the extent federal tax benefit is later allowed for the foreign taxes levied upon the combined income or alternatively, for administrative convenience, California could compute tax merely using after-tax rather than pre-tax net income. Cal. Rev. & Tax Code § 23057 (Stat. 1955, ch. 938, § 7) (West 1979) provides that if any portion of California's Bank & Corporation Tax Law is held unconstitutional, "such determination shall not affect the remainder of this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby." Thus, this Court may deem a portion of California's tax statute unconstitutional and order the tax to be computed on combined net income after allowance for foreign income taxes without invalidating the entire statute.

The above-described approach is not inconsistent with this Court's

(*footnote continued on following page*)

III.

THE CALIFORNIA WORLDWIDE UNITARY COMBINED TAX REPORTING METHOD, AS APPLIED, VIOLATES THE DUE PROCESS AND EQUAL PROTECTION CLAUSES OF THE FOURTEENTH AMENDMENT TO THE UNITED STATES CONSTITUTION AND BURDENS FOREIGN COMMERCE.

The constitutional requirement of even-handed law enforcement is applicable to tax measures. *Sioux City Bridge Co. v. Dakota County*, 260 U.S. 441 (1922); *Home Telephone & Telegraph Co. v. City of Los Angeles*, 227 U.S. 278 (1913); *Raymond v. Chicago Union Traction Co.*, 207 U.S. 207 (1907).

California's extension of unitary combined tax reporting to include overseas affiliates discriminates against businesses operating internationally (as opposed to intranationally) especially those with foreign ownership. This discrimination stems from the gross distortion, *i.e.*, disproportionate taxation relative to the level of in-state activity or income, caused by application of this taxing method beyond U.S. borders.[15] Further, foreign affiliates doing no business in California are forced to combine their tax-adjusted financial results with those of related domestic companies. The concomitant heavier administrative

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pronouncement in *Mobil*, 445 U.S. 425. This method is basically a "source" rule which meets the requirements in *Mobil* to adequately determine what income does or does not have a foreign source. In the context of unconstitutional double taxation, there should be no distinction between "allocated" versus "apportioned" methods of sourcing income.

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[15] "Such methods [i.e., worldwide combined reporting] would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises in tending to

(*footnote continued on following page*)

and fiscal burden placed upon international business in initially supplying financial statements and records and subsequently identifying, quantifving, and supporting essential tax adjustments in an attempt to avoid such distortion is *per se* discriminatory. This burden is an unacceptable impediment to foreign commerce. *See* General Accounting Office, *Report to the Chairman, House Committee on Ways & Means, supra* note 13, at 37-40; Cal. Rev. & Tax Code Regulation §25137(m) (codifying administrative practice, approval pending before California Office of Administrative Law).

Whether or not this heavier burden on foreign commerce was intended by the California legislature or Franchise Tax Board is irrelevant. A tax which is discriminatory in effect is nonetheless unconstitutional even where "the unequal operation of the taxing system was due to inadvertence rather than design." *F.S. Royster Guano Co. v. Virginia*, 253 U.S. 412, 415-16 (1920). The Court has recognized a constitutional exception to formula apportionment in state taxation whenever the result is unworkable or unfair. *Norfolk & Western Railway Co. v. North Carolina*, 297 U.S. 682 (1936); *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931).

California justifies extending its domestic tax method internationally on the erroneous assumption that a three factor formula, "while not perfect, reflects more accurately

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ignore the managements own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses. . . ." *Organization for Economic Cooperation and Development Fiscal Affairs Comm. Report, Transfer Pricing and Multinational Enterprises* 14-15 (1979). *See also State Taxation of Foreign Source Income; Hearings on H.R. 5076 Before The House Ways and Means Comm.*, 96th Cong., 2d Sess. 3, 4 (March 31, 1980) (Statement of Assistant Treasury Secretary Donald C. Lubick).

the realities of the business and tax world." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 282 (1978) (Blackmun, J., dissenting). The three factor formula typically fails to take into account the considerably greater economic diversity worldwide than domestically.[16] The United States cannot tolerate any state tax apportionment method that discriminates against and burdens foreign commerce by calculating the tax liability of a multinational corporation based upon rough approximations and not upon more precise economic formulations. *See International Harvester Co. v. Evatt, Tax Commissioner*, 329 U.S. 416, 422 (1947). This burden is even more intolerable when the Court considers the voluminous data about overseas affiliates' activities exacted from taxpayers by California tax authorities. While such approximations and adher-

[16]"Moreover the operations carried on in foreign countries may be very different from those conducted in the U.S. Thus, in industries that depend on natural resources, the underdeveloped low-wage countries are frequently the source of the basic raw materials used in the industry, whereas the high-wage industrialized countries do the manufacturing. Hence, the wage and property costs in the two sets of countries are not comparable, since they relate to different operations. Furthermore, foreign markets may require the manufacture and sale of different qualities, grades or character of products in the same industry, from those made and sold in the U.S." J. Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 Tax Notes 155, 164 (1982).

A Commissioner's Note to Uniform Division for Tax Purposes Act (UDITPA) §11 (Property Factor), 7A *Uniform Laws Annotated* 102 (West 1978) states: "This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property at eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable."

ence to a three factor formula may be tolerable in an economically homogeneous domestic context, it is totally unacceptable in the more complex and sensitive global community. *See Japan Line*, 441 U.S. at 456.

Taxpayers and tax collectors alike suffer from the lack of comprehensive guidelines necessary to effectively resolve the distortion issue in the international context when worldwide unitary combined tax reporting is employed. This Court recognized in *Hans Rees'* that "evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." 283 U.S. at 134. Moreover, in *Norfolk*, 297 U.S. at 685, the Court pointed out that those primarily concerned with state taxation cannot be left without practical aids of ready application.

The approach in *Norfolk* is indicative of the Court's sensitivity to the impact of geographically divergent economic conditions. Although *Norfolk* involved domestic tax apportionment, the Court suggested an approach to resolve the distortion issue which may be applicable to apportionment on a worldwide basis. Adjustments to the normal three factor apportionment formula (which California and other unitary states reluctantly allow)[17] is appropriate where there is higher than average in-state operating costs relative to lower than average in-state sales. Situations, for example, such as start up operations, where the unitary ties to an overseas affiliate often appear to be the strongest, will benefit from this approach, thus alleviating some of the burden on foreign commerce.

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[17]*See* Hellerstein, *supra* note 16, at 155.

Until the *Container* and *Chicago Bridge* cases, the Court has had no real opportunity to consider the distortion issue in a multiple corporate international context. This Court is urged to fashion sorely needed guidelines for taxpayers, state revenue authorities and courts to test for constitutionally unacceptable distortion in international unitary situations.

CONCLUSION

This Court is respectfully urged to reverse the ruling of the California Court of Appeal. In the event the Court affirms the California court, it is urged to expressly limit its ruling to tax reporting methods as applied to United States-based multinationals.

Respectfully submitted,

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I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and a resident of the County of Los Angeles, over the age of eighteen (18) years and not a party to the within action or proceeding; that my business address is 3340 Ocean Park Boulevard, Suite 3005, Santa Monica, California 90405: that on July 30, 1982, I served the within *Amici Curiae in Support of Appellant* in said action or proceeding by depositing true copies thereof, enclosed in a sealed envelope with postage thereon fully prepaid, in the United States mail at Santa Monica, California, addressed as follows:

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I declare under penalty of perjury that the foregoing is true and correct. Executed on July 30, 1982 at Santa Monica, California.

Kirk W. Harney
(Original signed)

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,

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v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF AS AMICI CURIAE IN SUPPORT OF BRIEF OF CONTAINER CORPORATION OF AMERICA

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QUESTIONS PRESENTED

Whether the allocation of taxable income between the United States and foreign nations for income tax purposes is a subject of such dominant federal interest and responsibility that regulation of the subject must be prescribed by the United States government, to the exclusion of any regulation by individual states; and

Whether world-wide combined reporting for state unitary tax purposes is unconstitutional because it obstructs the prerogative of the United States government to conduct foreign relations.

TABLE OF CONTENTS

QUESTIONS PRESENTED i
TABLE OF AUTHORITIES iv
INTEREST OF THE AMICI CURIAE 1
SUMMARY OF ARGUMENT 3
ARGUMENT:

I.

The Allocation Of Taxable Income Between Nations Is A Field Of Such Primary Federal Interest And Is So Closely Involved With The Conduct Of Foreign Relations That Any State Regulation Of This Subject Is Constitutionally Barred Under The Commerce Clause And The Supremacy Clause 4

II.

State Income Tax Apportionment Formulae Must Reach Results Consistent With International Income Tax Treaties 11

III.

World-Wide Combined Reporting Is Unnecessary For State Income Tax Purposes 14

IV.

World-Wide Combined Reporting And The Unitary Method Of Apportionment Frequently Produce Multiple Taxation, Thus Imposing Impermissible Burdens On International Commerce 17

V.

The States Cannot Provide Due Process To Enterprises Subject To International Double Taxation 18
CONCLUSION 20

TABLE OF AUTHORITIES

Cases

Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924) 12, 13
Chae Chan Ping v. United States, 130 U.S. 581 (1889) 5
Chy Lung v. Freeman, 92 U.S. 275 (1876) 5
Hines v. Davidowitz, 312 U.S. 52 (1941) 9
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 5, 9, 10, 12
Knox v. Lee, 79 U.S. 457 (1870) 5
Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976) 5
Southern Pacific Co. v. Arizona, 325 U.S. 761 (1945) 5, 6, 9
Western Livestock v. Bureau of Revenue, 303 U.S. 250 (1938) 17
Zschernig v. Miller, 389 U.S. 429 (1968) 5, 8, 9

Constitutional Provisions

U.S. CONST. art. I, § 8, cl. 3 4
U.S. CONST. amend. V 18
U.S. CONST. art. VI, cl. 2 4

Statutes

Internal Revenue Code § 482 14
Internal Revenue Code § 551-558 16
Internal Revenue Code § 951-964 16
Treasury Regulation § 1.482-1(b)(1) 14

Other Authorities

CCH Tax Treaties, Vol. 1, ¶1317P (1980) 8, 10
CCH Tax Treaties, Vol. 2, ¶8103DC, 8107-29 (1976) 8
Defendant's Reply to Plaintiff's Opposition Brief in Alcan Aluminum Ltd. v. The Franchise Tax Board of the State of California, United States District Court, S.D.N.Y. 81 Civ. 3911 (L.W.P.) page 18 19
OECD, International Investment and Multi-national Enterprises—Recent International Direct Investment Trends 103 (1981) 17
Press Release by British Information Department, Reprinted in Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 317 (1980) 7
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF AS *AMICI CURIAE* IN SUPPORT OF BRIEF OF CONTAINER CORPORATION OF AMERICA

INTEREST OF THE *AMICI CURIAE*

Your *amici* are major Canadian companies engaged in the banking, distilling, nickel mining, forest products, and casualty insurance industries. All conduct the major part of their business activities outside the United States, but have significant business interests in the United States, primarily through American subsidiaries. All are detrimentally affected by world-wide combined reporting, imposed by various states of the United States.

The interest of the *amici* in the instant case arises from the following factors:

i) Their grave concern that if the various states of the United States are permitted to require world-wide combined reporting under varying allocation formulae, subordinate taxing authorities of other countries may adopt similar procedures, thus severely impairing the flow of international commerce;

ii) The irreconcilable problems of multiple taxation that necessarily result from applying different methods of allocating income among the states of the United States and foreign nations;

iii) The absence of any international tax court to resolve problems of multiple taxation and the unconstitutionality of resolving such problems by treaties between foreign nations and the individual states of the United States;

iv) The arbitrary and inaccurate allocation of income, frequently resulting from world-wide combined reporting under the unitary method of apportionment, together with the onerous expense and the diversion of management time required to prove by clear and cogent evidence that an allocation of income is totally disproportionate;

v) The substantial compliance problems that confront your *amici* who are required to gather and present, in varying state-required formats, world-wide financial data, which must be converted into United States currency in the context of constantly fluctuating exchange rates and presented in accordance with local state income tax principles.

Your *amici* are not concerned with the use of combined reporting for a unitary enterprise within the United States. They are very concerned with international use of world-wide combined reporting by various states of the United States.

SUMMARY OF ARGUMENT

The allocation of income and related expense between the United States and other nations for income tax purposes is so integral to the conduct of foreign relations that it constitutes a field of dominant federal interest, prohibiting any state regulation. This dominant federal interest precludes world-wide combined reporting and apportionment of taxable income by the unitary method because this procedure not only conflicts with the established federal "arm's length-independent entity" method of allocation but also prejudices the conduct of foreign relations.

World-wide combined reporting in compliance with the unitary method is totally inconsistent with the internationally accepted "arm's length-independent entity" principle. The multiple taxation that inevitably arises imposes burdens on international commerce that are impermissible under the Commerce Clause.

Multi-national enterprises are denied due process at the international level because no international tax court or administrative procedures exist to resolve the multiple taxation arising from the conflict between world-wide combined reporting and the unitary method of apportionment as used by certain states of the United States and the "arm's length-independent entity" principle applied by all industrialized foreign nations. At the federal level, "competent authority" procedures to avoid double taxation have been established by tax treaties with those foreign nations that constitute the major trading partners of the United States. Some measure of due process is thus afforded under the federal scheme.

The problems of state involvement in foreign relations, multiple taxation and lack of due process would cease to exist if this Court were to prohibit state allocation of a greater amount of taxable income to the United States than is permitted by international tax treaties of the United States or the Internal Revenue Code of the United States.

World-wide combined reporting is unnecessary since the United States Internal Revenue Service establishes the fair share of global income subject to original taxing jurisdiction in the United States in accordance with the tax treaties of the United States and the Internal Revenue Code. The states can apply their apportionment formulae to this fair share of global taxable income already apportioned to the United States. Further, given stringent United States enforcement of tax treaties and the tax avoidance provisions of the Internal Revenue Code, world-wide combined reporting is not required to prevent tax avoidance.

ARGUMENT

I.

THE ALLOCATION OF TAXABLE INCOME BETWEEN NATIONS IS A FIELD OF SUCH PRIMARY FEDERAL INTEREST AND IS SO CLOSELY INVOLVED WITH THE CONDUCT OF FOREIGN RELATIONS THAT ANY STATE REGULATION OF THIS SUBJECT IS CONSTITUTIONALLY BARRED UNDER THE COMMERCE CLAUSE AND THE SUPREMACY CLAUSE.*

When called upon to constrain state infringement of the exercise of federal authority, this Court has returned repeatedly to its statement that:

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* U.S. CONST. Art. I, § 8, cl. 3 and Art. VI, cl. 2.

> "The United States is not only a Government, but it is a national Government, and the only Government in this country that has the character of nationality. It is invested with power over all the foreign relations of the country, war, peace and negotiations and intercourse with other nations; all which are forbidden to the state governments."

Chae Chan Ping v. United States, 130 U.S. 581, 605 (1889); *See also Knox v. Lee*, 79 U.S. 457, 555 (concurring opinion) (1870).

States exceed their constitutional power in our federal system when they attempt to regulate commerce among nations, particularly when such regulation affects the conduct of foreign relations. This Court recently reiterated in *Japan Line, Ltd. v. County of Los Angeles*, the long-accepted constitutional doctrine that:

> "'[T]he commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce. . . . [I]n such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests."

441 U.S. 434 at 454, quoting *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 769 (1945).

In functioning as such an arbiter, this Court has been keenly sensitive to the federal government's need to "speak with one voice when regulating commercial relations with foreign governments," *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976); to the potential magnitude of repercussions that could be precipitated by "real or imagined wrongs to another's subjects inflicted, or permitted, by a government," *Zschernig v. Miller*, 389 U.S. 429, 441 (1968); and to the likelihood that any adverse response provoked by state interference in matters of foreign affairs would be directed at the United States rather than toward any individual state or locality, *Chy Lung v. Freeman*, 92 U.S. 275, 279 (1876).

If the allocation of taxable income between nations for state income tax purposes is a "matter of local concern [that] is local in character and effect," insignificantly impacting upon foreign commerce, and if the incentive to deal with the subject nationally is slight, state regulation of this field should be held constitutional; otherwise it is unconstitutional. *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 767. Your *amici* respectfully submit that world-wide combined reporting in pursuance of the unitary method of taxation cannot be regarded as a "local concern" nor one "local in character and effect."

Indeed, protests by many of our nation's major trading partners demonstrate that international applications of state-imposed unitary apportionment methods are "inimical to the national commerce." 325 U.S. at 769. Almost universally, foreign governments and corporations perceive the international application of state unitary apportionment schemes as unjustified attempts by individual states to extend their taxing power beyond the territorial boundaries of the United States.* The Italian government, on its own behalf and on behalf of nine EEC governments, expressed this concern as follows:

> "Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States. . . .

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* Anger at what is perceived to be extra-territorial foreign taxation can be a United States, as well as a foreign sentiment. This is vividly demonstrated by the experience between the United States and France in the late 1920's. The French took a view that state world-wide combined reporting enthusiasts might well understand, arguing that dividends or interest paid by United States corporations, in part out of income from French operations, were to that extent French source income, subject to French securities taxes. Complaints about extra-territorial taxation by the French flooded the State Department. International consultations were held. Ultimately, the United States' first bilateral Tax Convention was signed on April 27, 1932. Under the Convention, France abandoned her security tax.

> *This method is incompatible with the principles accepted by all OECD member [countries] and recommended to all [countries] as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises.* These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at 'arm's length' between the subsidiary and related enterprises." (Emphasis added.)*

The British government has stressed the risk of continued state interference with pre-existing federal policy concerning the allocation of income between nations, emphasizing the destructive impact of such interference on prior international agreements and the adverse effect of such state action on otherwise attainable goals of international cooperation.

> "Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally *it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment*, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that *the unitary basis*, which is not a practical international alternative to the 'arm's length' basis, *could undo the important and patient international work that has been achieved in regulating international tax practices*, and that every effort is required to discourage the use [or] the extension of that basis." (Emphasis added.)**

In connection with the new Income Tax Treaty with Canada signed September 26, 1980, the Deputy Prime

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* *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 360 (1980).

** *Press Release by British Information Department, Reprinted in Hearings on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 317 (1980).

Minister and Minister of Finance for Canada, Allan J. MacEachen, by letter dated September 26, 1980, advised the United States Treasury that:

> "It is the position of Canada that the so-called 'unitary apportionment' method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. . . . Canada continues to be concerned about this issue as it affects Canadian multi-nationals."*

In the face of such undeniable international complaints, the United States Department of State has expressly categorized the issue of international income apportionment as a subject for resolution through the only constitutional mechanism for formulating international agreements—the exercise of the treaty power of the United States government. In his letter transmitting the 1975 Income Tax Treaty between the United States and the United Kingdom to the President, C. W. Robinson, acting Secretary of the Department of State reported:

> "The [state unitary] method of assessment, which includes the burden of producing worldwide records of all of the affiliated companies, has raised many objections by our treaty partners and we are now seeking to deal specifically with this problem in our treaties."**

State regulation that impacts upon foreign relations or jeopardizes the power of the United States government to deal comprehensively with international problems must be invalidated. This Court thus held in *Zschernig v. Miller*, 389 U.S. 429, when presented with a state statute that had received far less international attention than has

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* *See* CCH Tax Treaties, Vol. 1, ¶1317P (1980).

** *See* CCH Tax Treaties, Vol. 2, ¶8103DC at 8107-29 (1976).

world-wide combined reporting for unitary tax purposes. Invalidating an Oregon statute that had limited the right of East German residents to inherit from a decedent resident in Oregon, this Court concluded that the Oregon statute was "an intrusion by the State into the field of foreign affairs which the Constitution entrusts to the President and to the Congress." *Id.* at 432.

Zschernig is consistent with this Court's holdings that state legislation must be held unconstitutional when it "is in a field which affects international relations, the one aspect of our government that from the first has been most generally conceded imperatively to demand broad national authority." *Hines v. Davidowitz*, 312 U.S. 52, 68 (1941). This Court has never required a comprehensive scheme of federal regulation as a prerequisite to invalidating state interference in an area of exclusive federal concern.

As in *Zschernig*, wherein this Court relied on no federal descent statutes to invalidate the state scheme, invalidation of state regulation in the instant case does not require a finding that the federal government has either exhausted, or begun to exercise, its regulatory powers over the international allocation of taxable income. The subject matter and its need for uniform treatment trigger the need for federal control, regardless of the extent of federal exercise of that control. *See Southern Pacific Co. v. Arizona*, 325 U.S. 761.

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, this Court found that taxation of the instrumentalities of international commerce was a direct regulation of such commerce, requiring uniformity of approach and centralization of authority, and, therefore, held that such power was exclusively vested in the United States government. Similarly, the instant case presents an issue of critical international importance, which, although not yet entirely regulated by treaties, is vital to the

maintenance of both international trade and international relations.

The division of income and taxing power is at the core of virtually every federal income tax treaty negotiated by the United States. State regulation of international income allocation has precipitated a level of international frustration and complaint that should forewarn those who would ignore this Court's admonition in *Japan Line* that:

> "The risk of retaliation . . . is acute, and such retaliation of necessity would be felt by the Nation as a whole. . . . California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade."

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. at 453.

That Congress has not enacted legislation restricting combined reporting to the territorial limits of the United States and that efforts to do so through the treaty-making power were denied ratification* does not render constitutional state regulation that was inherently unconstitutional from the outset. When a field is one of exclusive federal interest and responsibility, the states have no constitutional power to intervene. Concurrent state regulation cannot be tolerated. Even when the United States government has not acted, state conduct that is inimical to the national commerce or disrupts the conduct of foreign relations is unconstitutional. Your

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* See letter of September 26, 1980, from G. William Miller, Secretary of the Treasury, to Allan J. MacEachen, Deputy Prime Minister and Minister of Finance for Canada, CCH Tax Treaties, Vol. 1, ¶1317P. The unitary method of apportionment was not an international problem until 1970-1975; consequently, earlier tax treaties did not attempt to deal with this issue. The states that created the problem then frustrated an attempted treaty solution rather than remove the problem by limiting combined reporting to the United States.

amici submit that world-wide combined reporting is both inimical to the national commerce and disruptive of the conduct of foreign relations.

State regulation of international income tax matters, which regulation is impermissible under the constitutional division of power between the United States government and the various states, does not become constitutional merely because the United States government has not acted or because individual states through their Senators refuse to ratify an income tax treaty intended to prohibit such regulation.

II.

STATE INCOME TAX APPORTIONMENT FORMULAE MUST REACH RESULTS CONSISTENT WITH INTERNATIONAL INCOME TAX TREATIES.

Your *amici* urge this Court to hold, as a minimum, that a state apportionment formula, if used consistently by all states in relation to a particular foreign country, must not allocate to the United States any greater amount of taxable gross income, or lesser amount of expense related to that income, than is permitted or required by any United States income tax treaty with that country. When the severity of international tax problems has prompted the United States government to negotiate an income tax treaty with a country, the dominant federal interest is clear.* The United States has negotiated such treaties with approximately forty nations, creating a comprehensive framework of understandings, between the United States and other countries, regarding the means by which taxable income will be allocated among them. Individual state assertions of the power to allocate income by means other than those used in treaties in-

* Since state income taxes are deductible for federal income tax purposes, an adverse effect on federal revenue results whenever world-wide combined reporting allocates more income to the United States than is allocated by the United States Internal Revenue Code.

evitably undermine such understandings and expectations. The problem becomes increasingly acute as the more commercially significant states of the United States adopt world-wide combined reporting, often after a tax treaty has been negotiated.

Foreign governments cannot enter into treaties with individual states; they must rely upon the United States government's authority in negotiating trade policies. To permit as many as fifty independent state assertions of taxing authority over international commerce would frustrate the United States government's attempts to speak with one voice in negotiating agreements dealing with international trade, investment, and financing. This Court is respectfully urged to reaffirm the exclusive authority of the United States in this field.

As this Court held in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), the need for, as well as the existence of, a uniform federal policy is imperative. Only this Court can ensure that state law does not frustrate the effectuation of that uniform federal policy.

This Court's opinion in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), does not deny the need to preclude state interference in the allocation of taxable income between nations. *Bass, Ratcliff* was decided on facts arising in 1918, only five years after income taxation had been instituted in the United States. The United States had not yet entered into any income tax treaties with foreign nations and did not do so until the first treaty with France in 1932.* Conflicts between state income apportionment formulae and the provisions of treaties, the consequent adverse effect on foreign relations, and risks of international multiple taxation were not considered in *Bass, Ratcliff* because they did not exist or were not yet perceived as

* *See* Richard E. Titlow *International Double Taxation and the United States*, 46 Taxes, The Tax Magazine 135 (1968).

national problems. This Court has never, however, failed to update constitutional interpretation to meet the needs of changed circumstances—in this case, the enormous growth of international trade, investment, and financial transactions since World War II, making necessary numerous international tax treaties.

Under the current United States-United Kingdom Income Tax Treaty, if Bass, Ratcliff had not had federal taxable income, under the proposition advocated by your *amici*, Bass, Ratcliff would probably also have had no taxable income in the State of New York. However, once income and expense attributable to the United States had been ascertained under the treaty provisions, New York could have calculated a profit on the New York state income tax return by denying a deduction otherwise allowable on the federal return. In such a situation, while the state and federal tax results would not be consistent, no state interference in the treaty allocation of income *among nations* would occur. This result would be consistent with the constitutional allocation of foreign commerce power exclusively to the United States.

In the converse of *Bass, Ratcliff*, with an American company selling ale in the United Kingdom through a branch established there, the current Income Tax Treaty between the United Kingdom and the United States would permit the United States government to include, for federal income tax purposes, all income and expenses of the United Kingdom branch. The approach urged by your *amici* would allow a state of the United States to include in its apportionment all British income, sales, property, and payroll, because the income and expense incurred in England could be taken into account for federal income tax purposes under the treaty.

III.

WORLD-WIDE COMBINED REPORTING IS UNNECESSARY FOR STATE INCOME TAX PURPOSES.

Conflicting state and national assertions of power to allocate taxable income may be reconciled by applying state unitary apportionment formulae only to that quantum of taxable income that is allocated to United States sources pursuant to international tax treaties of the United States and the Internal Revenue Code of the United States. Since most states use federal taxable income as the starting point for computing state income taxes, this limitation is practical, as well as fair.

Tax treaties and the regulations under Section 482 of the Internal Revenue Code use the "arm's length-independent entity" principle to allocate income and expense not only between the components of a "unitary" business, but also between all entities under "common control."* Section 482 governs a wider range of situations than those intended by the unitary principle. The federal approach is based on the concept of "com-

* "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. *The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.*" (Emphasis added.) Treasury Regulation 1.482-1(b)(1).

mon control," a test easier to apply than the inquiry required to determine whether a business is "unitary." The results achieved are also more precise than the often rough approximations necessitated by mechanical application of mathematical formulae to combined income.

Internal Revenue Service procedures under Section 482 of the Internal Revenue Code and the regulations promulgated thereunder include in United States gross income all amounts properly attributable to United States sources, allocating to foreign sources all expenses not properly attributable to United States sources and denying United States deductions for those expenses. The result maximizes taxable income in the United States.

The detailed and sophisticated rules applied by the Internal Revenue Service govern, for example, the imputation of interest on otherwise interest-free loans; the appropriate charges by a United States parent company to its foreign subsidiary for use of managerial, technical, or financial services or for royalties on patents or trademarks; and the calculation of a fair price for goods sold between a parent and its subsidiary. Although difficult to apply in some instances, when the rules are applied, they focus on economic realities, and their application can be dealt with item by item at the audit level. These precise results render unnecessary the rough approximations of formulary apportionment.

When the United States government has performed the task of allocating taxable income and expense to the United States, no need exists for totally different apportionment formulae nor for imposing on taxpayers the additional expense and diversion of management time required to prove by clear and cogent evidence that the state allocation of income is totally disproportionate.

The states argue that apportionment of income by the unitary method is essential to prevent taxpayers from manipulating separate geographical accounting and from distorting taxable income, and also because an army of state revenue agents would be required to enforce the "arm's length-independent entity" method. These considerations are totally irrelevant in the international context, because the task of allocating a fair share of global taxable income and expense to the United States is performed routinely every year by the Internal Revenue Service, and its Office of International Operations which was created for this express purpose.

To avoid misallocation of income and expense and to effect compliance with tax treaties and domestic tax law, the tax authorities of the United States and foreign governments also exchange tax information. Moreover, the Internal Revenue Service has "simultaneous examination programs" with Canada, Germany, France, and the United Kingdom, providing for the separate but simultaneous audit of the same multi-national enterprise. In addition to Section 482 of the Internal Revenue Code and these audit procedures, the "foreign personal holding company" and "Sub-Part F" provisions of the Internal Revenue Code* include within United States taxable income the earnings of foreign subsidiaries in tax haven countries.

With such comprehensive regulation by the federal government, state systems for world-wide combined reporting cannot be justified by any alleged need to prevent tax avoidance. Moreover, with approximately seventy to seventy-three percent of investment flowing from the United States to Japan, Canada, and European countries whose corporate income tax rates nearly all equal or exceed those in the United States,

* I.R.C. §§551-58, 951-64.

and with eighty-eight percent of foreign source investment originating in those same countries, shifting of income out of the United States tends to increase, rather than to reduce, tax rates.*

In summary, your *amici* contend that state-imposed world-wide combined reporting cannot be justified as a necessary evil that is required to eliminate or reduce tax avoidance.

IV.

WORLD-WIDE COMBINED REPORTING AND THE UNITARY METHOD OF APPORTIONMENT FREQUENTLY PRODUCE MULTIPLE TAXATION, THUS IMPOSING IMPERMISSIBLE BURDENS ON INTERNATIONAL COMMERCE.

As this Court noted in *Western Livestock v. Bureau of Revenue*, 303 U.S. 250, 255-56 (1938), unconstitutional multiple taxation arises where the tax burdens are of:

> "[S]uch a nature as to be capable, in point of substance, of being imposed . . . with equal right by every state which the commerce touches, merely because interstate commerce is being done, so that without the protection of the commerce clause it would bear cumulative burdens not imposed on local commerce."

Combined reporting ignores the individual commercial realities of particular corporate branches and subsidiaries, apportioning combined income on the basis of factors such as sales, property, and payroll. World-wide combined reporting assumes that a dollar of sales, property, and payroll in one country will produce approximately the same amount of income in any other country. Although arguably true as between the states of the United States, this assumption ignores interna-

* U.S. and OECD statistics are approximately the same. See, *e.g.*, United States Department of Commerce, Bureau of Economic Analysis, Vol. 61, No. 8, *Survey of Current Business* (1981) 21, 41; OECD, *International Investment and Multinational Enterprises—Recent International Direct Investment Trends*, (1981) 103, 105.

tional realities. Varying economic conditions and profitability levels in different countries ensure that world-wide combined reporting and the "arm's length-independent entity" method will produce substantially different results on the same facts. These differences are often exacerbated by currency values fluctuating internationally by up to twenty percent or more in any year.

Whenever combined reporting and the unitary method of apportionment allocates to the United States a greater amount of taxable income than the "arm's length-independent entity" method, multiple taxation inevitably follows because foreign nations do not correspondingly decrease the amount of taxable income allocated to them by the latter method.

V.

THE STATES CANNOT PROVIDE DUE PROCESS TO ENTERPRISES SUBJECT TO INTERNATIONAL DOUBLE TAXATION.

Within the United States, this Court can prevent multiple taxation arising from conflicting methods of allocation of taxable income between the states, thereby insuring fundamental fairness to the taxpayer. Conflicts between world-wide combined reporting and the "arm's length-independent entity" approach, resulting in multiple taxation at the international level, cannot be resolved either by this Court or by any other court. No international tax court or administrative procedures exist to resolve conflicts in allocation of taxable income between individual states and foreign nations. In the absence of a forum in which he can be heard, the taxpayer can have no due process.* Asking the courts of the individual state or foreign nation to resolve the conflict is ineffective as each must be guided by its domestic law. An allocation of income by the unitary method may not be sufficiently disproportionate to require it to be set aside as a denial of due process, and yet such an alloca-

* Required by U.S. CONST. amend. V.

tion is frequently totally different in result from the "arm's length-independent entity" method.

States cannot defend the resulting multiple taxation by alleging that such multiple taxation is the fault of foreign nations that use the "arm's length-independent entity" method. It is not the prerogative of an individual state of the United States to tell a foreign nation that it should deviate from accepted international practice and subordinate the "arm's length-independent entity" method of allocation to the unitary method.* Further, the absence of any international tax court with jurisdiction to hear such questions emphasizes the need for international tax treaties to establish the administrative review procedures necessary to resolve such conflicts and the need to require the individual states of the United States to adhere to the constitutional scheme that vests the United States government with exclusive power to conduct international relations.

If individual states were required to apply their apportionment formulae and individual tax rules to gross income and expense allocable to the United States in accordance with federal tax treaties and the Internal Revenue Code, taxpayers would be afforded some measure of due process. The international tax treaties of the United States provide that when conflicting allocations of income and expense occur between two countries, the taxpayer has a right to require the "competent authorities" (as defined in the tax treaty) of each country to meet and reconcile conflicts.

Such procedures are not applicable to double taxation caused by state deviation from accepted international methods of allocating income. Foreign nations and their taxpayers cannot constitutionally enter into treaties with

* This is the position taken by California in its Defendant's Reply to Plaintiff's Opposition Brief in *Alcan Aluminum Ltd. v. The Franchise Tax Board of the State of California*, United States District Court, Southern District of New York, 81 Civ. 3911 (L.W.P.) page 18.

individual states to establish procedures for solving such conflicts. Your *amici*, therefore, respectfully request a remedy from this Court.

CONCLUSION

Your *amici* urge this Court to hold that state apportionment formulae must not allocate to the United States any greater amount of taxable income or lesser amount of expense than is permitted or required by the international tax treaties and Internal Revenue Code of the United States.

This result is dictated by the need for this nation to speak with one voice in international affairs. This need cannot be met if the issue of international income allocation remains susceptible to the parochial preferences of up to fifty different states.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

BRIEF OF CATERPILLAR TRACTOR CO. AS AMICUS CURIAE IN SUPPORT OF APPELLEE

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QUESTION PRESENTED

Does California's use of the combined method of apportionment to determine the amount of Container's income properly apportionable to California for state income tax purposes violate the Commerce Clause?

TABLE OF CONTENTS

	PAGE
QUESTION PRESENTED	i
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iii
INTEREST OF CATERPILLAR TRACTOR CO.	1
SUMMARY OF ARGUMENT	2
ARGUMENT	4
I. MISAPPORTIONMENT OF INCOME	5
II. DOUBLE TAXATION	7
III. TAXATION OF FOREIGN INCOME-PRODUCING ENTITIES	9
IV. THE RULE OF NATIONS	10
V. SPEAKING WITH ONE VOICE	12
VI. TENSIONS	12
VII. NON-UNITARY BUSINESSES CANNOT BE COMBINED	14
VIII. BUSINESS SITUS DOES NOT DICTATE A STATE'S METHOD OF APPORTIONMENT	14
CONCLUSION	16

TABLE OF AUTHORITIES

Cases: PAGE

ASARCO Inc. v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (1982) 5, 7, 9, 13, 14

Barclay & Co. v. *Edwards*, 267 U.S. 442, 69 L.Ed. 703, 45 S.Ct. 135 (1924)..... 13

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82 (1924) 6, 8, 9, 11, 14

Bob-Lo Excursion Co. v. *Michigan*, 333 U.S. 28, 92 L.Ed. 455, 68 S.Ct. 358 (1948)..... 13

Caterpillar Tractor Co. v. *Lenckos*, 84 Ill.2d 102, 417 N.E.2d 1343 (1981), *prob. juris. noted sub. nom. Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, (No. 81-349) (U.S. Sup. Ct.).. 2, 5, 7, 11, 13

Container Corp. of America v. *Franchise Tax Board*, 117 Cal. App.3d 988, 173 Cal. Rptr. 121, *appeal filed*, 50 U.S.L.W. 3177 (No. 81-523)..... 5, 11, 13

Dept. of Revenue of Washington v. *Association of Washington Stevedoring Companies*, 435 U.S. 734, 55 L.Ed.2d 682, 98 S.Ct. 1388 (1978)..... 14

Exxon Corp. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207, 65 L.Ed.2d 66, 100 S.Ct. 2109 (1980)..... 14

F. W. Woolworth Co. v. *Taxation & Revenue Dept.*, 50 U.S.L.W. 4957 (1982) 7, 9, 13, 14

Hans Rees' Sons, Inc. v. *North Carolina*, 283 U.S. 123, 75 L.Ed. 879, 51 S.Ct. 385 (1931)..... 7, 15

Hines v. *Davidowitz*, 312 U.S. 52, 85 L.Ed. 581, 61 S.Ct. 399 (1940)..... 11

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434, 60 L.Ed.2d 336, 99 S.Ct. 1813 (1979)..... 7

Maine v. *Grand Trunk Ry. Co.*, 142 U.S. 217, 35 L.Ed. 994, 12 S.Ct. 121 (1891)..... 9

PAGE

McCulloch v. *Maryland*, 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579 (1819) 11

Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980) 3, 8, 11, 13

Moorman Mfg. Co. v. *Bair*, 437 U.S. 267, 57 L.Ed.2d 197, 98 S.Ct. 2340 (1978) 7

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113, 65 L.Ed. 165, 41 S.Ct. 45 (1920) 6

Union Brokerage Co. v. *Jensen*, 322 U.S. 202, 88 L.Ed. 1227, 64 S.Ct. 967 (1944) 15

Wallace v. *Hines*, 253 U.S. 66, 64 L.Ed. 782, 40 S.Ct. 435 (1920) 9

Western Live Stock v. *Bureau of Revenue*, 303 U.S. 250, 82 L.Ed. 823, 58 S.Ct. 546 (1938) 15

Wisconsin v. *J. C. Penney Co.*, 311 U.S. 435, 85 L.Ed. 267, 61 S.Ct. 246 (1940) 9

United States Constitution:

Commerce Clause, Article I, Section 8, Clause 3 ..... i, 1, 2, 3, 4, 5, 7, 13, 14, 15, 16

Fourteenth Amendment, Section 1 ..... 2, 4, 12, 14

Miscellaneous:

The Federalist No. 32 (J. Cooke ed. 1961) (Hamilton) 11

Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, As Amended, S. Exec. Rep. No. 96-5, 96th Cong., 1st Sess. 6 (June 15, 1979), *reprinted in* 2 Tax Treaties (CCH) ¶8103DF 10

Tax Treaties with The United Kingdom, The Republic of Korea and the Republic of the Philippines, Hearings Before the Senate Committee on Foreign Relations, 95th Cong., 1st Sess. (1977) 10

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INTEREST OF CATERPILLAR TRACTOR CO.

Caterpillar Tractor Co. ("Caterpillar"), with the consent of the parties, submits this Brief as Amicus Curiae in support of Appellee's position that worldwide combination does not violate the Commerce Clause. Caterpillar is the parent of a multicorporate unitary business enterprise, incorporated in California and headquartered in Illinois. Its twenty-six wholly-owned subsidiaries operate in the United States and abroad. Collectively, they constitute the largest manufacturer and marketer of earth-moving, construction and material handling equipment in the world.

Like Container Corporation of America ("Container"), Caterpillar has also been taxed by a state on the basis of a worldwide combined report. Unlike Container, however, Caterpillar believes that the combined method of reporting properly recognizes the integrated nature of a unitary business, and thus results in a tax that is both fairly apportioned and constitutionally valid.

The constitutionality of worldwide combination as applied to Caterpillar is the subject of an appeal presently pending in this Court. *Caterpillar Tractor Co.* v. *Lenckos*, 84 Ill.2d 102, 417 N.E.2d 1343 (1981), *prob. juris. noted sub. nom. Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, (No. 81-349). The disposition of the present case may affect the issues in question in Caterpillar's case.

SUMMARY OF ARGUMENT

Appellant contends that application of worldwide combined reporting inherently violates the Commerce Clause (U.S. Const. art. 1, § 8, cl. 3). The record in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, (No. 81-349) establishes, however, that this apportionment method is constitutional both on its face and in effect when applied to the domestic parent of a worldwide unitary business. Indeed, combined reporting in the case of *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.* is the only method that fairly reflects the business activity of Caterpillar within Illinois.

Combined reporting is, in essence, the equivalent of formulary apportionment applied to a multicorporate unitary business. The combined method of apportionment is justified by the inability to isolate the source of profits earned by a nominally separate enterprise within the multicorporate group. It should not result in misapportionment of income when the business is truly integrated. If distortion occurs because the various facets of the business are in fact discrete, or if the business is unitary and significant misapportionment nonetheless occurs, the Due Process Clause (U.S. Const.

amend. XIV, § 1), rather than the Commerce Clause, affords relief to a taxpayer.

Combined reporting takes into account the "underlying economic realities of a unitary business." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 441, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980). It is irrelevant that Container or Caterpillar chooses to operate as a domestic parent with foreign subsidiaries rather than as a single domestic corporation engaged directly in foreign business. It must be conceded that in this latter case, no unconstitutional double taxation results. Caterpillar submits that the corporate formalities existing in the former instance cannot render the same tax unconstitutional under a theory of double taxation.

Although combined reporting looks to out-of-state values in order to determine the amount of in-state income properly taxable, only the domestic corporation, in form and in substance, is taxed. Foreign assets and shareholders are unaffected by California's use of a combined apportionment formula.

There is no support for Appellant's and Amici's contention that worldwide combination violates the rule of nations. No treaty requires the states to tax domestic parent corporations in conformance with the federal arm's-length method. International custom is not implicated because California is not taxing a foreign entity. Our foreign trading partners have found no occasion to complain of variations from federal practice when the tax burden rests solely on a domestic parent corporation.

The worldwide combination of Container or Caterpillar does not infringe upon the government's ability to "speak with one voice." California's method of apportionment offends neither treaty nor foreign sovereign. World commerce is unfettered by California's tax on domestic parent corporations. Foreign countries, unaffected by apportionment of income of a domestic parent corporation, have not expressed concern with the tax imposed on Container or Caterpillar.

Rather, our trading partners have complained of the imposition of worldwide combination to apportion the income of foreign controlled unitary business enterprises. This question is not before the Court.

The distinction between foreign and domestic control may be irrelevant when a business is truly unitary. The issue is always one of limiting state taxation to the income earned within the state. If income is properly apportioned, constitutional rights are unimpaired. If income earned elsewhere is unfairly allocated to a state, the taxpayer may justly complain of a constitutional violation. The essence of the taxpayer's injury, however, is that its right to due process was infringed, rather than that the Commerce Clause was violated.

The framework of the Commerce Clause does not require this Court to dissect issues germane to worldwide combination of a domestically controlled unitary business enterprise. The questions dispositive of valid apportionment are within the exclusive province of the Due Process Clause. Those issues are, (1) whether the business enterprise is truly unitary and, if so, (2) whether the resulting apportionment significantly distorts the income earned within the state.

ARGUMENT

Appellant, Container, and substantially all of the supporting Amici urge this Court to rule that the apportionment of income of a domestically controlled unitary business enterprise by way of worldwide combination violates the Commerce Clause of the Constitution. Appellant and Amici catalog the alleged violations as including misapportionment of income, double taxation of income, taxation of foreign income-producing entities, violation of the rule of nations, interference with this country's ability to speak with one voice in foreign relations, and an irreconcilable conflict with the federal system which allegedly mandates the use of separate accounting by states.

Appellant's arguments are made in the context of its strenuous contentions that California improperly views Container and its foreign subsidiaries as a unitary business enterprise. If Appellant is correct, this appeal can be disposed of without reaching the constitutional objections to combination. *ASARCO Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (1982). However, as we understand Appellant's and Amici's contentions, their arguments are premised upon the assumption that the use of worldwide combination by a state violates the Commerce Clause even when applied to a unitary business enterprise.

Amicus, Caterpillar, respectfully submits that the constitutional issue raised by Appellant, i.e., whether combination of a domestically controlled worldwide unitary business enterprise to determine income properly apportioned to a state violates the Commerce Clause, can best be considered in the context of the record in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, (No. 81-349). The undisputed and extensive record in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.* establishes that Caterpillar operated worldwide with twenty-six subsidiary corporations. The Caterpillar operations were vertically and horizontally integrated and all parties agree that Caterpillar's worldwide business activities constitute a classic example of a unitary business enterprise. Illinois used worldwide combination to apportion the income of specific companies in the Caterpillar group to Illinois.

I. Misapportionment of Income.

The combination of Caterpillar's operations caused no misapportionment of income. If misapportionment of income is in fact present in *Container Corp. of America* v. *Franchise Tax Board*, (No. 81-523), it does not follow that the combination methodology is constitutionally flawed. Rather, such misapportionment is more likely attributable to the fact that there is insufficient economic interdependence to categorize the business enterprises of Container and its foreign subsidiaries as unitary.

The element critical to the justification of the use of formulary apportionment is a unitary business enterprise which ordinarily results in an inability to adequately identify earnings of a business enterprise on a separate basis. If *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 65 L.Ed.165, 41 S.Ct. 45 (1920) had involved Connecticut and Canada rather than Connecticut and New York, this Court's adoption of the use of formulary apportionment would have had equal application and validity. This was subsequently demonstrated by this Court's decision in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82 (1924), in which New York was not denied the right to tax the income derived from operations in New York simply because the taxpayer's method of accounting shifted all income to the United Kingdom.

In a truly unitary enterprise, the differing economic values existing in various geographic areas do not distort the apportionment. The income derived from an engine block manufactured in Peoria, Illinois, partially assembled in the United Kingdom, thereafter modified in France, incorporated in an earthmover in Belgium and finally sold to a Caterpillar customer in Saudi Arabia cannot be sourced on a geographic basis. The relative costs of labor, material, and sales (transportation) are melded into a unified economic effort. The contribution to the total profit made by the intervening economic activities are interdependent to each of the successive steps. While low wage rates of an area may impact upon the total pool of income, so too may high cost technology of another geographic area contribute inordinately to the pool of income. The method may be less than precise, but clearly combined apportionment fairly reflected the income earned in Illinois by Caterpillar and its domestic subsidiaries doing business in Illinois as a part of a worldwide unitary business enterprise.

If California has misapportioned Container's income because Appellant is not unitary with its foreign subsidiaries, Container's relief is dictated by this Court's decisions in

ASARCO Inc. v. *Idaho State Tax Commission,* 50 U.S.L.W. 4962 (1982) and *F. W. Woolworth* v. *Taxation & Revenue Dept.*, 50 U.S.L.W. 4957 (1982). If Container and its subsidiaries are engaged in a unitary business, but combination results in a demonstrable and significant misapportionment of the unitary business income to California, Container is also entitled to relief. *Hans Rees' Sons, Inc.* v. *North Carolina,* 283 U.S. 123, 75 L.Ed. 879, 51 S.Ct. 385 (1931); *Caterpillar Tractor Co.* v. *Lenckos,* 84 Ill.2d 102, 417 N.E.2d 1343 (1981). In either case, Container derives protection from its right to due process, not the Commerce Clause.

II. Double Taxation.

Appellant and supporting Amici argue that combination inevitably results in unconstitutional double taxation.[1] They contend that if Venezuela apportions and taxes income on a separate basis, California cannot also apportion and/or tax any portion of that income. The argument concludes that a state tax on any part of the income apportioned to Venezuela demonstrates an unconstitutional double tax which this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434, 60 L.Ed.2d 336, 99 S.Ct. 1813 (1979) prohibits.

The argument, framed in the context of a domestic parent and a Venezuelan subsidiary conducting a unitary business, must be tested in the context of a single California corporation engaged in business in Venezuela by way of a permanent establishment. Appellant's argument that the apportionment of income to California which is also apportioned to Venezuela (without regard to the propriety of the respective apportionment methods) results in double taxation ignores the possibility that Venezuela has taxed income properly apportionable to California. *Moorman Mfg. Co.* v. *Bair,* 437 U.S. 267, 57 L.Ed.2d 197, 98 S.Ct. 2340 (1978).

[1] Appellant and Amici ignore the record in *Chicago Bridge & Iron Co.* v. *Caterpillar,* (No. 81-349) which proves beyond question that worldwide combination does not always result in double taxation of a unitary business enterprise.

Appellant looks only to the result, i.e., apportionment of the same dollar of income by two jurisdictions. Appellant and Amici must concede, however, that the result complained of as unconstitutional double taxation, i.e., apportionment of income to two jurisdictions, is precisely the result that is admittedly constitutional in the case of the single California corporation engaged in business in Venezuela. In that case, California may unquestionably apportion income to California based upon in-state and out-of-state factors under formulary apportionment. *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924); *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980). Venezuela will still determine the income of the unitary business enterprise apportionable to it on the basis that the California corporation is in substance conducting a separate economic and independent business in Venezuela.

The overlap of income and the California and Venezuela tax are identical in either case. Does it follow in the case of a single corporation engaged in a unitary business in two jurisdictions that the taxation of income by both jurisdictions is constitutional, while interjection of a subsidiary corporation in Venezuela as a participant in the unitary business enterprise renders the same result unconstitutional as double taxation? We think not. This Court has not yet permitted corporate formalities attendant a given unitary business enterprise to dictate state tax consequences. In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 440 (1980), this Court rejected the taxpayer's argument that foreign dividends should be excluded from the apportionment base, stating:

> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would

meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. (Footnote omitted.)

III. Taxation of Foreign Income-Producing Entities.

Neither California nor Illinois has the right or authority to tax foreign values or foreign income. This Court has repeatedly stated that a clear and viable connection between the taxing state and the income taxed is a prerequisite to valid apportionment. *ASARCO Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (1982); *F. W. Woolworth Co.* v. *Taxation & Revenue Dept.*, 50 U.S.L.W. 4957 (1982). While no state can "reach profits earned elsewhere under the guise of legitimate taxation," (*Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. at 283), a state may look beyond its borders to "get the true value of the things within it, when they are part of an organic system of wide extent," *Wallace* v. *Hines*, 253 U.S. 66, 69, 64 L.Ed. 782, 40 S.Ct. 435 (1920). *See also, Maine* v. *Grand Trunk Ry. Co.*, 142 U.S. 217, 35 L.Ed. 994, 12 S.Ct. 121 (1891).

Appellant and supporting Amici urge that worldwide combination results in taxation of foreign values. This contention ignores the true function of combination as a method of apportionment. All parties recognize that a state may impose an income tax on a taxpayer having minimum necessary connections with the state. *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435, 85 L.Ed. 267, 61 S.Ct. 246 (1940). California cannot impose a tax on Container's Columbian subsidiary or its Venezuelan subsidiary or any of its other foreign subsidiaries if those subsidiaries have no nexus to California. What Appellant and Amici ignore in this case, is that in using combined apportionment California is not intending to tax the income of Container's foreign subsidiaries. Combined apportionment is used only to determine that amount of

income attributable to Container's contributions to the unitary business conducted in California. Only Container is required to pay a tax. There is no impact upon the foreign subsidiary or upon its minority shareholders. There is no diminution of the subsidiary's equity or assets.

IV. The Rule of Nations.

Appellant and supporting Amici contend that worldwide combination deviates from the federal arm's-length method of determining the taxability of income, thereby violating the rule of nations. They argue that income tax treaties in effect between the United States and the other countries of the world, as well as international custom, mandate that the states use the identical method of apportioning income as does the federal government.

Appellant and Amici, however, misconstrue the explicit language and spirit of the U.S. treaties in effect with foreign nations. Not a single compact limits the manner in which a sovereign may tax its domestic companies. Rather, the treaties specifically provide that the host country retains sole discretion to choose the method by which it will tax its own residents. Thus, Appellant and Amici must concede that no treaty presently limits California's right to tax Container by way of worldwide combination.[2]

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[2] Article 9(4) of the U.S./U.K. tax treaty as originally proposed would have prohibited California from applying combined reporting to the U.S. subsidiaries of U.K. corporate parents. It did not preclude California from using combination to determine the portion of unitary business income that a domestic parent, such as Container, earned within California. The Senate refused to ratify the treaty until the proposed limitation was removed. *See, Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, As Amended,* S. Exec. Rep. No. 96-5, 96th Cong., 1st Sess. 6 (June 15, 1979), *Reprinted in* 2 Tax Treaties (CCH) ¶8103DF. *See also, Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines, Hearings Before the Senate Committee on Foreign Relations,* 95th Cong., 1st Sess. (1977).

This Court has not accepted the argument that international custom demands uniformity between state and federal apportionment methods. Historically, states have enjoyed wide latitude in deviating from federal methods of taxation. *See*, Federalist No. 32 (J. Cooke ed. 1961) (Hamilton); *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 425, 4 L.Ed. 579 (1819); *Hines* v. *Davidowitz*, 312 U.S. 52, 68, 85 L.Ed. 581, 61 S.Ct. 399 (1940); *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924). As early as the decision in *Bass, Ratcliff*, this Court approved variations in state and federal practice. In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 448, this Court reaffirmed that no requirement of consistency between federal and state taxation of income exists:

> Concurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.

The application of the "rule of nations" is particularly illusory where, as in *Container* and *Caterpillar*, the state is attempting to determine the income of a domestic parent corporation. No foreign country is implicated. Logically, there is no greater need for consistency between state and federal methods where the domestic parent is part of a unitary worldwide enterprise than where it is a part of a unitary domestic enterprise. In either circumstance, the imposition of the tax falls upon the income of the domestic parent. Appellant's superficially appealing contention that international practice imperatively requires that California use separate accounting has no merit when used as a shield to legitimate taxation of income fairly apportioned to and earned within that state.

V. Speaking With One Voice.

The combination of Container or Caterpillar on a worldwide basis has had, and will have, no impact upon the federal government's ability to speak with one voice. Appellant and supporting Amici do not claim that California's or Illinois' use of combination in the instant cases has violated any treaty provisions. The treaties cited by Appellant and Amici each pertain to the agreed method of taxation of a corporation foreign to the treaty countries' jurisdiction. None of the treaties limits the sovereign in the manner in which it will tax its domestic companies. The United States taxes Container on its world income without apportionment and grants Container foreign tax credits or deductions. California may only tax the income that Container earns in California. The method of apportionment that California uses to determine the amount of income Container earns in California in no way impinges upon world commerce.

The constitutional propriety of California's determination of the income it apportions or allocates to California on account of Container's activities in that state is limited solely by the application of the Due Process Clause. California's actions with respect to Container do not legitimately concern the federal government or any foreign government. The issues raised in this case are strictly between Container and California.

VI. Tensions.

It is specious to argue that combination as applied to Container by California or Caterpillar by Illinois creates tensions between the U.S. and its foreign trading partners. Our foreign trading partners have no reason or right to question the methods or results of federal or state taxation of domestic parent companies. Venezuela has no legitimate concern with a state income tax imposed upon Container. The U.K. has no legitimate concern with a state income tax imposed upon Caterpillar. Foreign nations have indicated concern when states use combination to apportion the income

of foreign controlled unitary business enterprises. But clearly the expressed concerns do not address the issues Container raises herein.

The issue of whether or not the Commerce Clause may indeed erect a barrier to preclude the use of worldwide combination to apportion the income of foreign-owned unitary business enterprises is not before the Court. *Mobil Oil, ASARCO, Woolworth, Caterpillar* and *Container* all involve domestic parent corporations.[3] This Court has stated that the Commerce Clause will not protect a domestic corporation operating in a foreign territory where the business is of greater concern to American interests. *Bob-Lo Excursion Co.* v. *Michigan*, 333 U.S. 28, 36, 92 L.Ed. 455, 68 S.Ct. 358 (1948).

Any additional constitutional protection afforded foreign businesses is based upon this Court's recognition that domestic corporations have:

> the power of the United States to protect their interests and redress their wrongs in whatever part of the world their business might take them, while the foreign corporations must look to the country of their origin for protection against injury or redress of losses occurring in countries other than the United States. *Barclay & Co.* v. *Edwards*, 267 U.S. 442, 447, 69 L.Ed. 703, 45 S.Ct. 135 (1924).

The states may be prohibited from imposing inordinate burdens on foreign enterprises if our nation deems it expedient to avoid offending their sovereigns' sensitivities. In the specific context of this case it is unnecessary for this

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[3] *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980); *ASARCO Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (1982); *F. W. Woolworth Co.* v. *Taxation & Revenue Dept.*, 50 U.S.L.W. 4957 (1982); *Caterpillar Tractor Co.* v. *Lenckos*, 84 Ill.2d 102, 417 N.E. 2d 1343 (1981), *prob. juris. noted sub. nom. Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, (No. 81-349); and *Container Corp. of America* v. *Franchise Tax Board*, 117 Cal. App. 3d 988, 173 Cal. Rptr. 121, *appeal filed*, 50 U.S.L.W. 3177 (No. 81-523).

Court to walk an analytical tightrope between domestically-owned and foreign-owned enterprises. Perhaps they are constitutionally distinct; perhaps they are not. In this case the issue of interference with foreign commerce is not present.

VII. Non-Unitary Businesses Cannot be Combined.

ASARCO and *F. W. Woolworth* teach that categorization as a unitary business enterprise requires much more than common control and incidental business relationships.[4] In *Exxon Corp.* the Court described *"a highly integrated business which benefits from an umbrella of centralized management and controlled interaction"* as being unitary. *Exxon Corp.* v. *Wisconsin Dept. of Revenue,* 447 U.S. 207, 224, 65 L.Ed.2d 66, 100 S.Ct. 2109 (1980). This Court's opinions demonstrate that no one measure fits all factual situations, and that states cannot "reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission,* 266 U.S. 271, 283 (1924). If this Court determines that Container's operations are not unitary, application of combined apportionment to its non-unitary, discrete business enterprises is prohibited in all instances by the Due Process Clause.

VIII. Business Situs Does Not Dictate a State's Method of Apportionment.

The Commerce Clause clearly permits California to look to a unitary business operation to determine the share of income apportionable to California. The tangential use of foreign income as a computational tool is not unconstitutional, since ultimately "[n]o foreign business or vessel is taxed." *Dept. of Revenue of Washington* v. *Association of Washington Stevedoring Companies,* 435 U.S. 734, 754, 55 L.Ed.2d 682, 98 S.Ct. 1388 (1978). There is nothing talismanic about the situs of unitary operations. The fact that some of Container's or Caterpillar's subsidiaries are located beyond

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[4] *ASARCO Inc.* v. *Idaho State Tax Commission,* 50 U.S.L.W. 4962 (1982); *F. W. Woolworth Co.* v. *Taxation & Revenue Dept.,* 50 U.S.L.W. 4957 (1982).

the "water's edge" does not sound the death knell for a properly apportioned state income tax.

It is respectfully submitted that there is no constitutional reason which prevents California from applying worldwide combination to a domestically controlled unitary business enterprise if the taxpayer fails to establish that combination of its business enterprise has resulted in a meaningful distortion of income. *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931). It is not the purpose of the Commerce Clause to relieve those engaged in foreign commerce from their "just share of state tax burden even though it increases the cost of doing the business." *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 254, 82 L.Ed. 823, 58 S.Ct. 546 (1938). To argue otherwise verges on the frivolous. The Commerce Clause does not shield Container from California's efforts to exact its just share of money due it in return for the use of the state's services. *See, Union Brokerage Co.* v. *Jensen*, 322 U.S. 202, 88 L.Ed. 1227, 64 S.Ct. 967 (1944).

Amicus Caterpillar respectfully submits that the threshold issue presented to the Court by this case is whether Container is, in fact, a participant in a unitary business enterprise with its foreign subsidiaries. The gravamen of Container's complaint must rest with California's definition of a unitary business enterprise and whether, if unitary, the resulting apportionment significantly distorts the income of Container. *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931).

CONCLUSION

If this Court approves the decision of the California Court of Appeal that Container's worldwide operations constitute a unitary business enterprise, Caterpillar respectfully urges the Court to affirm the lower court's decision that combination does not violate the Commerce Clause.

August, 1982

Respectfully submitted,

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF CITIZENS FOR TAX JUSTICE; AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES; CITIZEN/LABOR ENERGY COALITION; CONSUMER FEDERATION OF AMERICA; INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS; INTERNATIONAL UNION OF OPERATING ENGINEERS; NATIONAL COUNCIL OF SENIOR CITIZENS; AND SERVICE EMPLOYEES INTERNATIONAL UNION: AS *AMICI CURIAE* IN SUPPORT OF THE CALIFORNIA FRANCHISE TAX BOARD

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TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
INTEREST OF *AMICI CURIAE*	2
STATEMENT OF GENERAL CONSENT	4
SUMMARY OF ARGUMENT	4
ARGUMENT	5
Introduction	5
I. The facts of this case show that California's determination of Container's California source income is not "unreasonable," but is instead well within the bounds of "rough approximation"	7
II. Formula apportionment of the worldwide income of unitary businesses is an appropriate means for the states to determine the in-state income of multinational firms	13
III. California is not unconstitutionally undermining the foreign policy of the United States by its use of worldwide formula apportionment, nor has Congress violated the constitution by its repeated refusals to restrict the power of the states to use the worldwide formula approach	20
IV. The decision of how to measure the in-state taxable income of multinational firms is a political question which the constitution leaves to the states and (perhaps) to the Congress	21
CONCLUSION	25

TABLE OF AUTHORITIES

Cases — Page

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) 8

Hans Rees' Sons, Inc. v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1981) 7, 8

Hines v. *Davidowitz*, 312 U.S. 52 (1941) 21

Japan Line Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 21

Mobil Oil Corp. v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) 6

Moorman Manufacturing Co. v. *Blair*, 437 U.S. 267 (1978) 7, 22

Norfolk & Western Railway Co. v. *Missouri State Tax Commission*, 390 U.S. 317 (1969) 7, 8

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 7, 8

Statutes and Rules

California Revenue and Taxation Code, section 25137 18

Internal Revenue Code of 1954

Section 482 ..... *passim*

Section 861 ..... 16, 17, 24

Subpart F, sections 951 *et seq.* 9

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Page

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TABLE OF AUTHORITIES—Continued

Page

Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. (1977) .. 7, 16, 18, 20

U.S. Department of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1980 (1982) 22

U.S. Department of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1975-1976 (1979) 22

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INTEREST OF AMICI CURIAE

The decision of the Court in this case will affect the right of California, as well as other states, to assess a fair share of the tax burden on multinational corporations. It will therefore directly affect both state and local taxpayers and state and local government workers, since a decision against the State of California in this case is likely to mean increased personal taxes, reduced government services, or both in the states which are affected.

As representatives of middle- and lower-income taxpayers and of state and local government workers, *amici* therefore have a vital interest in the outcome of the case before the Court:

Citizens for Tax Justice (CTJ) is a coalition of national public interest organizations, labor unions, and citizens groups around the country. CTJ was founded in 1979 and is headquartered in Washington, D.C. Through its member organizations, CTJ represents the interests of tens of millions of middle and lower-income taxpayers. Several of CTJ's members also represent state and local government workers around the country, including California.

The American Federation of State, County and Municipal Employees, AFL-CIO, is a national labor organization with approximately one million members throughout the United States and 19,000 members in California.

The Citizen/Labor Energy Coalition (C/LEC) is a national alliance of over 300 labor, senior, neighborhood, environmental and religious groups across the United States. C/LEC was founded in 1978 and is headquartered in Chicago, Illinois. Through its member organizations, C/LEC represents millions of citizens concerned

that multinational energy companies pay a share of taxes commensurate with the benefits received from, and business conducted in, the various states. Many of these citizens live in California.

The Consumer Federation of America (CFA) is composed of approximately 200 national, state and local organizations, including consumer, labor, farm, cooperative and senior citizen groups. CFA was formed in 1968 and is headquartered in Washington, D.C. Altogether, CFA's member organizations represent in excess of thirty million consumers, many of whom are California taxpayers.

The International Association of Machinists and Aerospace Workers, AFL-CIO, is a national labor organization representing approximately 900,000 workers in the airline, aerospace, shipbuilding and auto-related industries and in general manufacturing. Approximately 130,000 of its members are California taxpayers.

The International Union of Operating Engineers, AFL-CIO, is a national labor organization representing 405,000 workers, including operators of heavy equipment in the construction industry and stationary engineers operating plant and equipment in all major industries. It represents 65,000 workers in California, approximately 10,000 of whom are employed by government agencies.

The National Council of Senior Citizens represents approximately 4,000,000 senior citizens in 4,000 local clubs, area and state councils across the United States. Almost 300 of its affiliates are located in California. The National Council of Senior Citizens was founded in 1961 and is headquartered in Washington, D.C.

The Service Employees International Union, AFL-CIO, is a national labor organization representing approximately 675,000 workers in building service, health care,

government and other industries. It has 135,000 members in California, approximately 80,000 of whom work for government agencies.

STATEMENT OF GENERAL CONSENT

This brief is filed with the written consent of both parties, under a general consent on file with the Court, pursuant to Rule 28 of this Court.

SUMMARY OF ARGUMENT

California's application of a three-factor formula to the worldwide profits of unitary businesses is an inherently sensible approach to determining the in-state taxable income of multinational companies which has produced eminently reasonable results on the facts of this case. In fact, it is the alternative, arm's-length method argued by Container to be constitutionally mandated which has the highest potential for inherent arbitrariness and which would lead to the most unreasonable results here.

California's use of the worldwide formula approach no more unconstitutionally undermines the foreign policy of the United States than have Congress's repeated refusals to prohibit the states from using the formula system.

At bottom, the controversy in this case is not a constitutional one. Instead, it is a political dispute. California and several other states seek a fair sharing of their tax burdens and administrable tax systems, while Container and some other multinational firms seek reduced state tax bills. The resolution of this ongoing quarrel should properly be left to the political process.

ARGUMENT

Introduction

The dispute in this case is, on the facts, a narrow one. Container Corporation, a multinational business operating in California, numerous other states, and several foreign countries,[1] contends that California has asserted its tax jurisdiction over approximately one percent more of Container's income in 1963-65 than is permissible under the U.S. Constitution. The amount of California tax in dispute, not counting interest, averages about $24,000 per year—or less than 1/10th of one percent of Container's average pretax income in 1963-65. Put another way, Container seeks a ruling from this Court that California has overstepped constitutional bounds by refusing to reduce Container's state income tax bill by 12 percent.

This narrow factual dispute, however, overlays a far more significant and fundamental issue involving the constitutional power of the states to adopt reasonable measures to determine the in-state taxable income of multinational firms.

Container's specific complaint in this case is with California's inclusion of Container's worldwide income in the base for apportioning taxable income to California under the familiar three-factor, property-payroll-sales formula. Container maintains that the formula should have been applied solely to what Container asserts are its U.S. profits, determined under a separate-accounting, arm's-length approach. In support of its position, Container asserts, first, that its foreign operations do not constitute a "unitary business" with its U.S. operations, and, second, that, even if a unitary business does exist, California's formula approach is "inherently

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[1] Since the tax years in question, Container has itself become a subsidiary of another multinational company, Mobil Corporation.

arbitrary" and has produced results which are "unreasonable" on the facts of this case.

This brief will leave to other participants in the case the task of defending California's treatment of Container as a unitary business. Suffice it to say here that we believe the evidence is overwhelming that the unitary classification is correct. The remainder of the brief will explain why we believe that the California formula applied on a worldwide basis is a reasonable means for California—and other states—to use in measuring the share of a multinational corporation's income properly taxable within the state.[2]

It should be noted at the outset that, while *per force* the appellant in this case is seeking a reduced state tax bill, California's use of the worldwide formula approach is not based on an attempt to tax out-of-state income. As the non-partisan staff of the congressional Joint Tax Committee explained in 1977:

> "the application of the combined reporting [system] does not automatically 'tax' the income of the related corporations whose income, sales, payroll, and property values are taken into account. It only includes all of these items in the apportionment formula, and it may either decrease or increase the taxable income from sources within the State attributed to the corporations. . . . Viewed in this way

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[2] Actually, the questions of whether Container is a unitary business and whether California's formula approach produces a reasonable result substantially overlap. One of the reasons why California's system is appropriate—in fact, necessary—to determine Container's California taxable income is the substantial opportunities for transfers of expertise, good will, borrowing power, technical assistance, and so forth from Container's U.S. operations to its foreign subsidiaries without proper accounting for the costs of these items. Thus, just as a finding of "unitary business" is the "linchpin" of formula apportionment, Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 439 (1980), so a finding that formula apportionment is reasonable suggests the existence of a unitary business.

combined reporting is essentially an attempt to define the amount of income properly attributable to each entity and for each taxing jurisdiction." [3]

Container's burden in this case is to show either that "the method of apportionment adopted by [California] was inherently arbitrary, or that its application to this corporation produced an unreasonable result." *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920). It argues both, but proves neither.

In addition, Container maintains that California, through its use of the worldwide formula approach, and, apparently, Congress, by its repeated failure to prohibit the states from so doing, are unconstitutionally undermining the foreign policy of the United States. This argument, too, has no merit.

I. The facts of this case show that California's determination of Container's California-source income is not "unreasonable," but is instead well within the bounds of "rough approximation."

This Court has stated on numerous occasions that it will find the results under a formula apportionment approach "unreasonable" only "when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that state,' [*Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931),] or has 'led to a grossly distorted result,' [*Norfolk & Western Railway Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 326 (1969)]." *Moorman Manufacturing Co.* v. *Blair*, 437

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[3] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 51-52 (1977) (Statement of Paul Oosterhuis, Legislative Council, Joint Committee on Taxation) (emphasis added) [hereinafter *Joint Committee Testimony*].

U.S. 267, 274 (1978).[4] Under these standards, the fact that the dispute in this case is over such a small portion of Container's income would seem to dispose of this factual issue without further investigation.

The California formula apportions a mere one percent more of Container's worldwide income to California than Container claims is correct under the separate-accounting approach it favors. The 12 percent difference between the parties in total apportionment to California must certainly be within the range of "rough approximation" mandated by the constitution, *id.* at 273[5]—whichever method of apportionment is theoretically more accurate.

Which is not to concede—as Container's brief would have the Court assume—that the income allocation produced using a separate-accounting approach is presumptively correct.[6] To the contrary, it is Container's highly touted "arm's-length" standard which leads to the most unreasonable results on the facts of this case. In par-

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[4] *See also* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 227 (1980).

[5] In Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920), Connecticut assessed its corporate tax on 47% of Underwood's net income, based on a single-factor property formula, while the company claimed that only 3% of its profits were actually earned in Connecticut. The Court held that Underwood had failed to prove the formula had produced "an unreasonable result."

In Hans Rees' Sons, Inc, v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931), the Court had the opportunity to amplify on what an "unreasonable" result might be. It found that clear proof that the formula allocated 83% of the company's income to the state while only 17% was earned there would qualify the taxpayer for relief under the "out of all appropriate proportions" standard. *Id.* at 135. A similarly "grossly distorted result" was found in Norfolk & Western Ry. Co. v. Missouri State Tax Commissioner, 390 U.S. 317, 326 (1968), where the taxpayer made an uncontested case that the state's tax assessment—more than double what the taxpayer claimed to be appropriate—was essentially groundless.

[6] Such a presumption on Container's part, of course, largely begs the factual issue before the Court.

ticular, Container would have the Court find that it earned an average of $1.3 million per year on its Panamanian "operations"—an amount representing over three times the disputed California apportionment in this case—even though it admits that the Panamanian subsidiary was a "non-operating holding company," Jt. App. 30, with no sales, property, payroll, or other business activity.[7]

Container's brief makes much of the argument that California's apportionment formula produces the "ludicrous" result of making it appear that Container paid close to one-hundred percent tax rates in Colombia and the Netherlands in the years in question. But Container fails to acknowledge that its own "separate-accounting" system produces the far more ludicrous result of showing a *357 percent* tax rate in Italy over the same period.[8]

The burden is not on California to show how Container has specifically manipulated the separate-accounting methodology to produce an unacceptable allocation of its income to foreign sources. In fact, the whole point of relying on the formula apportionment approach is to avoid such impossibly difficult questions. But a look at the record provides more than sufficient evidence of the possibilities of such misallocation. In general, Container took advantage of numerous opportunities to share its

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[7] The Panamanian subsidiary was set up in part to avoid U.S. federal taxes, Jt. App. 31. With the advent of Subpart F of the Internal Revenue Code in 1962, I.R.C. §§ 951 *et seq.*, and its subsequent strengthening, this scheme apparently no longer worked, and by 1968 the Panamanian subsidiary had been dissolved. In 1964 and 1965, Container's "Panamanian income" was essentially treated as earned in the United States for federal tax purposes, i.e., foreign "deferral" was disallowed under Subpart F. *See* Jt. App., Exhibits, at 7.

[8] According to Container's separate accounting system, the Italian subsidiaries earned a total of $101,696 in 1963-65, Jt. App., Exhibits, at 1, 3, 5, but Container says these same affiliates paid $363,433 in Italian income taxes, Jt. App. 84.

good will, borrowing power, expertise, and so forth with its foreign subsidiaries, often apparently at no charge. Of course, there is nothing wrong with Container helping its subsidiaries earn higher profits; in fact, such is to be expected of a unitary, integrated business. But when the costs of such assistance are assigned to the U.S. rather than overseas, the result is a misallocation of reported income.[9]

Some examples: Container made or guaranteed over half the loans received by its foreign subsidiaries, Jt.

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[9] The Treasury Department has described the general nature of the tax avoidance opportunities available to U.S. multinationals as follows:

> "U.S. taxpayers have many opportunities to avoid U.S. taxes by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations . . . . It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States. In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. . . . Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U.S. tax revenues can be substantial."

U.S. Dept. of the Treasury, THE PRESIDENT'S 1978 TAX PROGRAM 286-87 (Jan. 30, 1978), printed in *The President's 1978 Tax Reduction and Reform Proposals: Hearings before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 160, 442-43 (1978) [hereinafter *Treasury Testimony*, with citations to the Ways and Means hearing record]. A similar description of the tax avoidance/evasion opportunities available to multinational firms can be found in Comptroller General, IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL COMPANIES, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS 1-2 (1981) [hereinafter *GAO Report*].

App. 70. Each percentage point reduction in the interest rate paid by the subsidiaries would misallocate about $114,000 per year in net income to them.[10] Container also brokered, at a bargain rate, some 90 percent of the equipment purchases by the Latin American subsidiaries, Jt. App. 77, which could have been worth about $300,000 a year to the subsidiaries. Technical assistance to the Colombian and Venezuelan subsidiaries often went unreimbursed, Jt. App. 74-75, and based on the technical assistance fees paid by other subsidiaries, this aid may have been worth at least $400,000 per year. Container made direct sales of equipment to subsidiaries, apparently at below market prices in the years in question, Jt. App. 76-77, which may have saved the subsidiaries significant amounts. Container's sales of materials and stock in trade, at alleged arm's-length prices, averaged over $1 million per year, Jt. App., Exhibits, at 8.[11] Container shared its U.S. good will with the subsidiaries, by recommending them to its U.S. customers for overseas work, Jt. App. 32-33, apparently at no charge. Container's $4.3-5.5 million in annual product, design, and marketing research, Jt. App. 27, was made freely available to the subsidiaries

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[10] The total outstanding loan advances from Container to its foreign subsidiaries in the years at issue averaged $6,028,000. Total outside loans outstanding averaged $16,178,000, of which Container "guaranteed approximately one third," or about $5,393,000. Thus, the total of loans made or guaranteed by Container to the subsidiaries averaged approximately $11,421,000, or 51.4% of total outstanding loans. *See* Jt. App. 69-70. Each percentage point difference in the interest rate would therefore be worth about $114,000 per year. During the years in question, the IRS had no standards for evaluating such inter-affiliate loans. Under rules established in 1968, however, the minimum "safe-haven" interest rate for such loans averaged over 4 percentage points below the U.S. prime rate from 1968 to 1980. *See GAO Report, supra* note 9, at 16.

[11] Container tries to belittle these purchases of materials by pointing out that they were only a small percentage of total cost of goods sold. That fact is not dispositive or even important, however. After all, taxable profits are generally only a relatively small percentage of costs or sales, too.

when appropriate, as were samples of products, Jt. App. 33-35. Subsidiaries were assisted in setting up their own design laboratories, again taking advantage of Container's expertise, Jt. App. 35. Container helped with personnel management, Jt. App. 48, 50, 60-62, and applied its expertise to evaluate all major capital spending decisions, Jt. App. 39. It trained foreign employees in the U.S., Jt. App. 69. And so on and so on. The total value of these and other benefits provided to affiliates without proper reimbursement could easily exceed the approximately $3.9 million a year at issue between U.S. and foreign apportionment, not to mention the $2.6 million at issue if "Panamanian income" is excluded.

Container's brief makes several detailed economic arguments contending that California's formula apportionment system produces incorrect results in specific situations. All these arguments are interesting; none of them is convincing.[12] But most important, such economic the-

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[12] For example, Container devotes a significant portion of its brief to the contention that California's formula fails to take account of different levels of profitability in foreign versus domestic operations. Foreign operations, says Container, are generally more profitable because they are riskier. For evidence of this economically rather puzzling contention, it points to the testimony of a witness who, extrapolating from several studies of the U.S. stock and bond markets, suggested that "there is a profitability of foreign operations, across all countries, on average, over time, very often larger than that on the domestic operation." Jt. App. 148 (apparent transcription errors have been corrected). If this heavily qualified assertion is supposed to mean that corporate rates of return are lower in the U.S. than abroad, it would surprise most foreign corporate executives, since U.S. corporate profitability has generally been substantially higher than that of foreign firms. Compare, for example, *International Corporate Scoreboard*, BUSINESS WEEK, July 20, 1981, pp. 86 *et seq.* (showing for foreign-based firms an average return on equity of 11.7% and an average return on sales of 3.0%) with *Corporate Scoreboard*, BUSINESS WEEK, March 16, 1981, pp. 65 *et seq.* (showing for U.S. based firms an average return on equity of 15.3% and an average return on sales of 9.0%). It might also surprise the Treasury Department. One of Treasury's

orizing has no place before this Court. Even absent the staggering caseload burden faced by the Court, it is not appropriate for this Court to be asked to pore over financial statements and evaluate various economic theories every time a corporate taxpayer disputes a state's apportionment of its taxable income by a few percentage points.

II. Formula apportionment of the worldwide income of unitary businesses is an appropriate means for the states to determine the in-state income of multinational firms.

Container argues that formula apportionment of worldwide unitary income is always "inherently arbitrary." It contends that the *only* allowable method is the arm's-length, separate-accounting system. The question before the Court, then, is whether the arm's-length approach is so clearly correct and so clearly superior to the formula approach that the states are constitutionally required to use it. The answer to this question is no.

Container's panegyrical view of the arm's-length method is shared by few, if any, analysts who have studied the IRS efforts to utilize that approach under section 482 of the Internal Revenue Code. For example, a 1981 General Accounting Office (GAO) report found:

> "Representatives of all groups affected by and knowledgeable about section 482 enforcement under the arm's length standard have voiced continuous and substantive criticism of the regulations. The criticisms focus on the fact that section 482 enforcement creates a large administrative burden and that

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criteria for choosing which multinational firms to audit under its arm's-length approach is: "Consolidated worldwide profits [i.e., profitability] are higher than U.S. profits. This type of situation can be an indication that profits of the U.S. corporations are being diverted to a tax haven country." *GAO Report, supra* note 9, at 37.

> the end result . . . is too often unpredictable and subjective." [13]

After reviewing the years of effort by the Treasury in attempting to improve enforcement under the arm's-length standard, the GAO report concluded as follows:

> "*RECOMMENDATION TO THE SECRETARY OF THE TREASURY.* We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under Section 482, *including formula apportionment*, which would lessen the present uncertainty and administrative burden created by the existing regulations." [14]

We would be remiss not to point out that this recommendation elicited criticism from the Treasury Department, which wrote that, while "the arm's-length principle may have both conceptual and practical limitations in a world of integrated firms selling differentiated products," "[i]n terms of economic rationale, formula apportionment has little merit" as well.[15] As Container suggests in its brief, Treasury has traditionally criticized the formula apportionment method in its written statements.[16] But GAO's conclusion recommending reconsideration of a federal formula approach was based largely on Treasury's own statements about the terrible problems it has encountered in attempting to enforce the arm's-length system.

The GAO report quotes a former Deputy Assistant Treasury Secretary as lamenting how "impossible" it is to achieve better than "a rough and unproven estimate" of proper cost allocation under the arm's-length system.[17]

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[13] *GAO Report, supra* note 9, at 43.

[14] *Id.* at 53-54 (emphasis added).

[15] *Id.* at 93, 95.

[16] *See* Brief of Appellant, at 29-34.

[17] *GAO Report, supra* note 9, at 48.

Similarly, in 1978 the Treasury Department complained to Congress about the "substantial" revenue loss to the federal government which results from IRS's inability to police the arm's-length standard effectively, and noted:

> "Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. *But no one familiar with international tax planning believes that the Regulations have taken the tax incentive out of transfer pricing.*" [18]

As Treasury's 1978 statement notes, for the tax years at issue in this case, there were not even detailed regulations at the federal level to enforce the arm's-length standard.[19] But more important, the issuance of these regulations has not stemmed the frustration with section 482 and arm's-length, separate accounting or the criticisms of the inefficiency of tax enforcement under that approach.

Actions may speak louder than words, and, in fact, despite its protests to the contrary, Treasury typically has been unable to utilize a purely arm's-length approach in its own enforcement of the tax laws with regard to multinational companies—and instead has been moving away from the arm's-length approach to a significant degree. The 1981 GAO report found that "only 3 percent of the . . . IRS recommended section 482 adjustments [in the cases covered by the GAO study] were based on arm's length prices determined through uncontrolled transactions." [20] Twenty-two percent of the adjusted amounts were based on "safe-haven" rules which may

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[18] *Treasury Testimony, supra* note 9, at 443 (emphasis added).

[19] The 1981 GAO report explains that the IRS had little need for detailed regulations, "because it seldom used" section 482. *GAO Report, supra* note 9, at 3.

[20] *Id.* at 29.

have little or no relation to arm's-length pricing.[21] And two-thirds of the amounts adjusted were based on "alternative techniques," including such things as assigning an assumed profit margins to labor costs or sales.[22]

While some have quibbled with GAO's exact statistics,[23] there is little doubt that in a large proportion of the federal section 482 cases the information necessary to determine true arm's-length transfer prices has been unavailable, and "IRS agents and the courts have been left to determine the proper allocation on whatever ad hoc basis seems appropriate." [24] Faced with these difficulties, Treasury has been attempting to move toward the increased use of formulas and rules of thumb in international tax enforcement. Most notably, in 1977 Treasury issued new rules for apportioning corporate overhead, research and development costs, and interest expenses between domestic and foreign sources under section 861 of the Internal Revenue Code, a cousin of section 482. The centerpiece of the new rules is a series of formula apportionments, based on sales and assets.[25]

The complaints about the defects of the arm's-length allocation system have not been limited to the grumblings of tax collectors. Corporate taxpayers also have been extremely critical of IRS enforcement under section 482—and not merely of IRS techniques, but of the basic arm's-length philosophy. The GAO report cites a 1980 business survey which found that:

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[21] *Id.* at 29. As noted *supra*, for example, the "safe haven" interest rate has been well below the U.S. prime rate. *Id.* at 16.

[22] *Id.* at 29-32.

[23] *See id.* at 33, 83.

[24] *Joint Committee Testimony, supra* note 3 at 52.

[25] Treas. Regs. § 1-861-8. *See* 42 FED. REG. 1195 *et seq.* (Jan. 6, 1977) for the rules and the Treasury explanation of their formula approach.

> "Although [multinational firms are] composed of numerous legally separate entities, [a majority of the executives of such firms offering an opinion] reveal that their companies make most intercompany pricing decisions as though the organization is one economic unit. *This basic difference in philosophy between the IRS and multinational corporations is central to the Section 482 controversy.*" [26]

More specifically, reports the GAO, corporate officials have called outcomes under section 482 "arbitrary," and have complained that "the analytical approach to determining arm's length prices often leads to unreasonable results." [27]

"Arbitrary" and "unreasonable." The striking similarity between these business criticisms of the arm's-length method and the complaints Container and its corporate *amici* are now making about California's formula approach suggests that something less than principle may be at work here. That suspicion is strengthened by the praise in Container's brief for the formula approach employed under the section 861 source rules,[28] which several

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[26] Burns, *How IRS applies the intercompany pricing rules of Section 482: A corporate survey*, 52 J. TAX. 308, 314 (May 1980) (emphasis added), paraphrased in the *GAO Report*, *supra* note 9, at 45. The surveyed executives agreed with the quoted statement by a 49-41 percent margin, with 10 percent undecided. The Burns study also found that "[w]hile most [executives] seem to accept the basic arm's-length premise," 52 J. TAX., at 313, this acceptance went only so far as favoring a system of transfer pricing. In setting those transfer prices, most opposed a true arm's-length approach and favored instead such things as cost-plus pricing, safe-haven rules, profit splitting based on formulas, or other formula approaches. *Id.* at 309, 313.

[27] *GAO Report*, *supra* note 9, at 44.

[28] *See* Brief of Appellant, at 30-31.

commentators have criticized as too generous to multinational firms.[29]

No one who has studied this complex area of the tax laws in depth could honestly argue to this Court that the formula approach to apportioning multinational corporate income achieves perfect results in all instances.[30] But it is equally clear that the arm's-length approach is not the panacea Container claims it to be. The staff of the congressional Joint Committee on Taxation has summarized the views of international tax experts on the arm's-length versus formula apportionment issue as follows:

> "Given the problems which exist with the States' methods of apportionment under combined reporting and with the Federal Government's allocation rules, there is considerable disagreement as to which method is preferable in various situations." [31]

In fact, the large number of distinguished commentators who have argued in favor of the formula approach on a worldwide basis should by itself resolve this issue in California's favor. While reasonable minds, can, of

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[29] *See, e.g.*, M.J. McIntyre, *An Inquiry Into the Special Status of Interest Payments*, 1981 DUKE L. J. 765, 806 n. 132 (1981) ("The Treasury's source rule also contained many special rules that can only be explained as concessions to political exigencies."); Tax Reform Research Group, Comments on Proposed Regulations Dealing with Allocation and Apportionment of Deductions Between Domestic and Foreign Source Gross Income, Dec. 16, 1976 (unpublished comments submitted to the Treasury Department).

[30] In fact, California allows companies which feel that the formula produces unreasonable results to challenge those results in administrative proceedings, on a case-by-case basis. *See* section 25137 of the California Revenue and Taxation Code. The same provision for modification of formula apportionment on a case-by-case basis is contained in section 19 of the Uniform Division of Income for Tax Purposes Act, which has been adopted by 25 states and the District of Columbia.

[31] *Joint Committee Testimony, supra* note 3, at 52.

course, differ on the question of the "best" approach to apportioning the income of multinational firms, California has clearly chosen an approach which is by no means "inherently arbitrary"—either in theory or in the minds of numerous experts.[32]

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[32] *See, e.g.*, Harley, *International Division of the Income Tax Base of Multinational Enterprise: An Overview*, TAX NOTES, Dec. 28, 1981, at 1563, 1567 (Based on "a measured evaluation" of the arm's-length versus the formula approach to allocating multinational corporate income, "the formula approach is the better one. Perhaps the underlying reason for its superiority is that the formula approach makes no claims to achieve a perfect result. It recognizes, rather, that a perfect allocation is impossible, The unitary system seeks a reasonable division of income by formula. The arm's-length standard strives for reasonable accuracy, but it fails to achieve it, and its theoretical basis is unsound,"); P. Musgrave, *The U.K. Treaty Debate: Some Lessons for the Future*, TAX NOTES, July 10, 1978, at 27, 28 ("Proponents . . . [have] suggested that the arm's-length separate-accounting method is inherently closer to establishing the true source of profits and therefore is less arbitrary than the unitary approach. Such is far from the case. . . . The use of the unitary method as implemented by a factor formula is not perfect, but it places less of a burden on administrative resources than does enforcement of the separate-accounting-arm's-length approach. . . . [T]here is less danger of base slippage and discretionary profit shifting on the part of the taxpayer and there are fewer items which have to be audited and checked."); Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Businesses*, 10 URBAN LAWYER 181, 183 (1978) ("the [unitary] concept, in my view, . . . is required to determine properly the portion of a tax base reasonably attributable to a taxing state."); Comment, *Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1228 (1976) ("The unitary entity theory has certain clear advantages. Principal among these is its theoretical superiority as a means for ascertaining the true income of various MNC [multinational corporation] components."); Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 207-08 (1970) ("section 482 type adjustments do not appear to provide a satisfactory alternative to combined reporting. . . . It is, of course, the inadequacy of separate accounting . . . that provides the underlying rationale for formulary apportionment."

III. California is not unconstitutionally undermining the foreign policy of the United States by its use of worldwide formula apportionment, nor has Congress violated the constitution by its repeated refusals to restrict the power of the states to use the worldwide formula approach.

Container's final attack on worldwide formula apportionment consists of the contention that California is unconstitutionally subverting the foreign policy of the United States by failing to follow the IRS regulations on income allocation. Logically, this argument would seem to apply equally to the U.S. Congress for its refusal to prohibit the states from using the worldwide combination approach in taxing multinational companies. And, in fact, Container rehearses the same arguments it and others have made to the Congress in this regard, arguments which the Senate explicitly rejected when it stripped a restriction on state use of worldwide combination from a proposed tax treaty with the United Kingdom in 1978 and which the full Congress has repeatedly rebuffed for over 20 years by refusing to enact proposed legislation to restrict state formula apportionment powers.[33]

As Container's brief admits, the standard to be applied in resolving this issue is whether California's action and Congress' considered inaction "stand[] as an obstacle to

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[33] In 1978, the Senate refused to ratify the proposed tax treaty with the United Kingdom until a restriction on the states' use of the worldwide combination method with regard to foreign multinationals was deleted. In so doing, the Senate explicitly rejected contentions by the Treasury Department that such a restriction was appropriate to avoid "disconcerting . . . international relations." *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings before the Sen. Comm. on Foreign Relations,* 95th Cong., 1st Sess. 28 (1977). Since 1965, bills dealing with state taxation of multistate and multinational corporations have been introduced in every session of Congress, but none has been enacted.

the accomplishment and execution of the full purposes and objectives of Congress." *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941).[34] Merely to state the question clearly is to resolve it in California's favor. Beyond peradventure, Congress does not believe its "purposes and objectives" are contravened by California's use of worldwide formula apportionment. This Court has no need to protect Congress from a danger our legislators, after careful deliberation, have found insufficient to justify national interference with the sovereign taxing powers of the states.[35]

IV. The decision of how to measure the in-state income of multinational firms is a political question which the constitution leaves to the states and (perhaps) to the Congress.

The implicit assertion throughout Container's brief is that a decision in favor of California in this case would leave the states with unbridled power to tap unfairly the "deep pockets" of multinational firms. This is simply not the case, for a number of reasons.

First of all, the formula approach produces generally fair results—in the opinion of a great number of experts, the fairest results attainable given the complexities of international business transactions. Second, companies always have the option to move their operations outside a state's borders if they find its tax regime intolerable, a threat which they have used to great advantage in

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[34] *See* Brief of Appellant, at 35.

[35] Container's attempted reliance on Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979), is misplaced. That case involved a county tax on *instrumentalities* of foreign commerce which by treaty were exempted from federal taxes and customs duties under a policy which the Court found would be clearly undermined by state taxation. The dispute in the instant case, on the other hand, is over the *measurement of income* from various sources, and Congress has repeatedly refused to restrict state use of measurement techniques different from those spelled out in IRS regulations.

garnering a vast array of state and local tax breaks over the years.[36] Few, if any, states can be expected to adopt tax approaches which demonstrably drive businesses and jobs away. In this light, the fact that there has been no rush by multinational firms away from California, but instead a steady movement into the state, provides further evidence that the formula apportionment approach does not produce unfair results.[37] And finally, Container and its allies can always petition the U.S. Congress for relief—although we do not believe Congress should grant it.[38] In fact, multinational companies have brought this

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[36] *See, e.g.*, J. Jacobs, BIDDING FOR BUSINESS: CORPORATE AUCTIONS AND THE 50 DISUNITED STATES. (1979).

[37] Most notably, California even leads the country in attracting investment by *foreign-based* multinationals, despite the fact that many of them, by locating in California, may subject themselves to taxation based on formula apportionment of their worldwide income. According to reports published by the U.S. Census Bureau, California leads the nation in the number of foreign-owned firms with two or more establishments and has widened its lead over other states since the Bureau began its series of reports in 1975. In 1980, the last year for which data are available, California had 4,829 such foreign-owned establishments (1,130 more than second-place New York), compared to 1,999 in 1975 (325 more than second-place Ohio). U.S. Dept. of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1980, Table 6 (1982); U.S. Dept. of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1975-1976, Table 7 (1979).

[38] As this Court stated in Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280 (1978) (*dicta*):

> "It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions."

At least one congressional analyst has contended that even Congress may lack power to interfere with the states' taxing power by restricting worldwide formula apportionment. In a paper prepared in

issue repeatedly before Congress, and have been repeatedly rebuffed.

At bottom, the arm's-length versus formula apportionment controversy is not a constitutional question. It is a political issue, in which states are attempting to protect their tax bases and some multinational firms are seeking to lower their tax bills.

Quite naturally, corporate taxpayers, like most natural citizens, prefer to pay as little in taxes as possible. Accordingly, companies pursue every opportunity to create legal devices which allow them to escape taxation of their income.[39] Every dollar of legitimate taxation they are able to avoid, however, is a dollar which must be paid for by other taxpayers, either in increased taxes or reduced services. Particularly in the states, where balanced budgets generally are constitutionally mandated, tax avoidance imposes a heavy cost.

1978, Archie Parnell, Senior Staff Counsel to the Ways and Means Oversight Subcommittee, together with William L. Shraberg, a trial attorney with the Tax Division of the Justice Department, Gloria Dunbar, and Abbe Jolles, argued that "a court could conclude that a state, as a sovereign entity under our federal system, as long as a non-discriminatory state income tax does not violate the Commerce Clause, is free to structure its taxes in any manner it chooses. Such a conclusion would necessarily mean that [a restriction on the use of worldwide formula apportionment] would be found to be unconstitutional." Parnell, Shraberg, Dunbar, & Jolles, *Article 9(4) and the Constitution*, TAX NOTES, July 10, 1978, at 29.

[39] A 1980 study, for example, calculated that in 1980 the 23 largest oil companies would fail to report to state tax departments almost half the domestic profits they reported to the federal government. The estimated unreported income totalled $9.7 billion, resulting in a state revenue loss of over $450 million. The study blamed the failure by state governments to detect this underreporting largely on the use by a large number of states of a separate-accounting approach to allocating interstate income. Citizen/Labor Energy Coalition, *Where Have All The Profits Gone: A Study of State Undertaxation of the Oil Industry* (Washington, D.C. 1980) (mimeographed copy).

The states therefore have good reason to try to assure that their tax laws are effectively enforced. California, along with a number of other states, has concluded that adoption of the arm's-length approach would mean ceding its tax jurisdiction over multinational firms to the vagaries of federal enforcement under section 482 of the Internal Revenue Code.[40] California reasonably believes it can obtain the most accurate measurement of the taxable income earned in California by multinational firms such as Container through the use of a simple, fair, and administrable system of worldwide combined apportionment—a belief sustained by the well-documented shortcomings of the arm's-length methodology and the strong expert support for the formula approach.

California's preference for formula apportionment is a political choice as to the best way fairly to share its tax burden and protect its average individual and business taxpayers. It is no less a political choice than was its decision in 1972 to institute a system of tax withholding and declaration of estimated taxes. Nor is it any less political than the decision of states like Nevada and Texas to impose no corporate income tax at all or the choice of states such as Connecticut and Florida to impose corporate, but not personal, income taxes.

Having failed to overturn California's formula approach through the political process, Container and its

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[40] California's adoption of the federal allocation system would also apparently make it vulnerable to the vagaries of congressional "tax incentive" policies. In 1981, for example, Congress directed Treasury to modify at least temporarily its source rules under section 861 of the Internal Revenue Code, so that "the expenses related to all research activities conducted in the United States should be charged to the cost of generating U.S. source income, whether or not such research directly or indirectly is a cost of producing foreign source income." Staff of the Joint Committee on Taxation, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 142 (1981). The reason offered for the action was to try to encourage research activities in the United States. *Id.*

allies have now brought the issue before this Court. Their challenge, masquerading as constitutional, is actually a political one. It should be rejected.

CONCLUSION

For the foregoing reasons, we urge the Court to affirm the judgment of the court below.

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD
Appellee.

On Appeal From the Court of Appeal of California, First Appellate District

Brief of The Coca-Cola Company as *Amicus Curiae* In Support of Appellant

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TABLE OF CONTENTS

	Page
INTRODUCTORY STATEMENT	1
OPINIONS BELOW	1
INTEREST OF *AMICUS CURIAE*	2
SUMMARY OF ARGUMENT	3
ARGUMENT	3
DUE PROCESS	3
COMMERCE CLAUSE	11
CONCLUSION	18

TABLE OF AUTHORITIES

CASES:

	Page
Allied Stores of Ohio v. *Bowers*, 358 U.S. 522 (1959)	16
ASARCO, Inc. v. *Idaho State Tax Commission*, _____ U.S. _____, 50 U.S.L.W. 4962 (1982)	4, 5
F. W. Woolworth Co. v. *Taxation and Revenue Department of the State of New Mexico*, _____ U.S. _____, 50 U.S.L.W. 4957 (1982)	3, 4
Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979)	11, 13, 14
Mobil Oil Corp. v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)	3
Moorman Manufacturing v. *Bair*, 437 U.S. 267 (1978)	10
Norfolk & Western Railway Co. v. *North Carolina*, 297 U.S. 682 (1936)	10
Royster Guano Co. v. *Virginia*, 253 U.S. 412 (1920)	16
Ward Paper Box v. *Department of Revenue*, 638 P.2d 1053 (Montana Supreme Court 1982)	4
Wisconsin v. *J. C. Penney Co.*, 311 U.S. 435 (1940)	10

CONSTITUTION:

	Page
U. S. CONST. art I, § 8, cl. 3	2, 3, 11
U. S. CONST. amend. XIV, § 1	2, 3, 10, 11, 16

Table of Authorities – continued

BOOKS AND ARTICLES:

R. Cole, *Work, Mobility, and Participation* (1979) 6

Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 42 (1960) 5

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Brit. Firms Overseas (Taxation) Apr. 27, 1982 15

Ins. for Int'l. Research, *The Eur. and Middle East Tax Rep.*, April 27, 1982 15

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Rev. Proc. 65-17, 1965-1 C.B. 833 13

Rev. Proc. 70-18, 1970-2 C.B. 493 13

2 Tax Treaties (CCH) ¶ 8103 DC 14

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INTRODUCTORY STATEMENT

This brief is submitted by The Coca-Cola Company as *amicus curiae* in support of the appellant in the above-captioned case. Written consents of Appellant and Appellee are attached to this brief.

OPINIONS BELOW

The Opinion of the Court of Appeal of California, First Appellate District, is reported at 117 Cal. App. 3rd 988, 173 Cal. Rptr. 121 (1981); the memorandum opinion and judgement of the California Superior Court are not reported.

INTEREST OF *AMICUS CURIAE*

The Coca-Cola Company files income tax returns in forty-one states, undergoes frequent state income tax audits, and has been assessed by six states on a worldwide unitary basis. The Coca-Cola Company falls prey to worldwide unitary (or worldwide combination) assessments because The Coca-Cola Export Corporation, a subsidiary of The Coca-Cola Company, has itself subsidiaries which manufacture and/or sell Coca-Cola in more than 140 nations. The outcome of this case will directly affect The Coca-Cola Company's tax liability in the several states already using worldwide unitary taxation. Other states are considering the imposition of worldwide unitary taxation but are awaiting clarification of the method's constitutionality.

Although this Court has previously considered the concept of a unitary business on a worldwide scale, the constitutionality of using the three-factor formula to apportion worldwide income has never before been presented to this Court. The Coca-Cola Company believes this method of taxation violates both the Due Process and Commerce Clauses of the Constitution. The Coca-Cola Company has a direct interest in this case because it has been victimized by State violations of Constitutional guarantees and State interference with the authority of the Federal Government to conduct foreign relations.

SUMMARY OF ARGUMENT

Worldwide unitary taxation (or worldwide combination) is a method of taxing income in which, once a multinational group of corporations is determined to be a unitary business, worldwide business income is attributed to a state using a standard factor apportionment formula. This method of taxation, though approved by this Court for businesses conducted within the borders of the United States, is unconstitutional when used on a worldwide basis. Worldwide unitary taxation violates the Due Process and Commerce Clauses of the Constitution.

States frustrate a taxpayer's right to due process both in the way businesses are determined to be unitary and in the use of formulary

apportionment in attributing income to a state. States have consistently used a broad and vague definition of unitary business to allow the combining of discrete business enterprises. This unitization of businesses, sometimes on the basis of unity of ownership alone, has permitted states to draw into their tax jurisdiction unrelated income from outside their borders. Because formulary apportionment is applied to income earned in areas economically distinct from the United States, income is greatly distorted. These distortions allow states to tax income which is totally unrelated to the economic activity conducted within state borders.

Worldwide unitary taxation violates the Commerce Clause because states prevent the Federal Government from presenting a unified national approach in international commercial relations. Additionally, international multiple taxation occurs, a situation condemned by this Court. Foreign countries have decried the states' use of worldwide unitary taxation and have threatened retaliation.

Worldwide unitary taxation offends the Constitution of the United States by effectively denying taxpayers their right to due process and by frustrating international economic policy of the Federal Government. This Court should declare worldwide unitary taxation unconstitutional.

ARGUMENT

Due Process

In return for the protections afforded their businesses, interstate operations owe the states a fair compensation. Although states are virtual sovereigns in designing their systems of taxation, the Due Process Clause of the Fourteenth Amendment imposes two limitations on state authority to tax; first, a "minimal connection" must exist between the taxing state and the taxpayer's interstate activities; and, second, the income attributed to the state must bear some rational relationship to the intra-state values of the business. *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). Due process requirements are satisfied when a state taxes income from a unitary business partially conducted within its borders. Constituent corporations of a unitary business are substantially interdependent, creating a "flow of international trade." *F. W. Woolworth Co.* v. *Taxation and Revenue Department of the*

State of New Mexico, _____ U.S. _____, 50 U.S.L.W. 4957, at 4961 (1982). An increasing number of states are violating the rational relationship test by irrational impositions of the worldwide unitary method of taxation. States violate due process guarantees both by irrationally determining which businesses are unitary and by using an apportionment formula which produces constitutionally impermissible misattributions of income.

This Court has issued guidelines for determining when a business is unitary in *ASARCO, Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962; and *F. W. Woolworth Co.*, 50 U.S.L.W. 4957. States may apportion dividend income only when the ownership of the underlying stock occurs in the context of a unitary business. States can no longer find business income anytime a disputed item "contributes to" the taxpayer's business since all corporate income in some way "contributes to" the business. *ASARCO, Inc.*, 50 U.S.L.W. at 4967; *F. W. Woolworth Co.*, 50 U.S.L.W. at 4959. These decisions, to some degree, will curb the unbridled expansion of unitary treatment which has been eroding constitutional guarantees of due process. The extent of this erosion is perhaps best shown by the Montana Supreme Court's decision in *Ward Paper Box* v. *Department of Revenue*, 638 P.2d 1053 (1982), in which the Court found a paper container business to be unitary with a cattle-raising business. The cattle-raising business, a losing venture, was located in Montana. The only way Montana could tax the profitable paper container business was by somehow declaring the two businesses unitary. The Court seized three facts to justify the state's taxation of extra-territorial income: money from the paper container business was used to keep the cattle business afloat, a central accounting function served both businesses, and the cattle business "contributed to" the taxpayer's overall solvency by providing a federal tax deduction. This decision surpasses even the standards for a unitary business proposed by counsel for the California Franchise Tax Board.

Two longtime advocates of unitary treatment, Frank M. Keesling and John S. Warren, once discussed the unitary nature of a

hypothetical cotton company which acquired a copper mine. Even though the copper mine operated at a loss, and depended upon the profitable cotton business for its continued operation; and, despite common ownership, management and use of facilities, Messrs. Keesling and Warren declared that this business would not be unitary. Rather, the taxpayer would be engaged in two separate lines of business. The loss from the copper mine, they urged, should be apportioned to the states in which that *separate* unitary business was conducted. Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 42, at 54-55 (1960). The Montana Supreme Court, then, should have found Ward Paper Box engaged in two businesses, and taxed each business based on its individual connections with the State.

The standards set by this Court in *ASARCO, Inc.*, 50 U.S.L.W. 4962, and *F. W. Woolworth Co.*, 50 U.S.L.W. 4957, allow the same conclusion reached by Messrs. Keesling and Warren. Even though this Court has solved some problems precipitated by unitary taxation, the peculiar problems attending worldwide unitary taxation remain unresolved. With worldwide unitary taxation, a state, after finding that a multinational group of corporations is a single unitary business, compels that business to file its tax returns using the worldwide combination method of reporting. A worldwide business income figure before foreign taxes is determined, and then apportioned, using the particular state's factor apportionment formula. Container Corporation of America presents this Court with the opportunity to judge the constitutionality of the worldwide apportionment method. *Amicus* urges this Court to make that determination and not to conclude this case with a determination of Container Corporation's unitary status. A finding by this Court that Container Corporation of America is a unitary business does not determine the constitutionality of California's worldwide factor apportionment.

The states' overbroad definition of a unitary business has provided only one source of due process violations. States further undermine taxpayers' constitutional rights when they use the standard three-factor formula in apportioning worldwide income. No rational

relationship binds the income a state seeks to tax through worldwide unitary taxation to the intra-state activities of the taxpayer. The required rational relationship cannot exist because substantive economic differences separate the United States from the countries in which the income is earned. These economic differences effectively eliminate factor apportionment as a rational method of attributing income to a state.

Unlike Mobil Oil Corporation, *Amicus* does not now argue that a foreign source alone places income beyond the realm of state taxation. Rather, *Amicus* asserts that business operations in a foreign jurisdiction are subject to profitability factors so different from those in the United States that foreign income is earned in an economically distinct enterprise. Lumping such income before taxes together with domestic income in a single or multi-factor formula cannot produce a fair apportionment. Instead, income attribution becomes so distorted that no rationale supports the formula's use.

The seminal factual assumption underlying the viability of formula apportionment is that the United States enjoys economic consistency within its borders. This economic consistency means that the three-factor formula can assign to each state a more or less fair share of a taxpayer's income for taxation.

Economic inconsistency, however, is the hallmark of the world economy. Sales, property, and payroll change value and substance from country to country. Rather than smoothing out regional differences, as occurs in the United States, time exacerbates them. These economic inconsistencies skew the results of the three-factor formula. One glaring example of a distorting economic difference between the United States and a foreign country is the difference in wages between the United States and Japan. Labor in Japan's large industries enjoys a fringe benefit for which American labor is just now beginning to bargain – permanent employment. Permanent employment uniquely symbolizes Japanese industrial relations. Permanent employment means that an employee enters a company after graduation, is trained at the company and remains there until retirement at age 55. R. Cole, *Work, Mobility, and Participation*, at 11 (1979). Because employees will remain with a company for life,

employers invest heavily in training and impose the cost of that training on younger workers through lower wages. Permanent employment lessens the importance of financial rewards for labor and increases the importance of intangible rewards. Conversely, in the United States, a worker's reward is reflected chiefly in salary. R. Cole, *Work, Mobility, and Participation*, at 141, 255 (1979). The value of permanent employment as a fringe benefit defies translation into a dollar figure; yet, permanent employment is a very real constituent of a Japanese worker's wage. Not accounting for permanent employment in the wage factor distorts the effect of Japanese wages in apportioning income earned in Japan.

In addition to permanent employment, Japanese workers enjoy subsidized housing as part of labor's compensation. If subsidized housing is included when calculating Japanese "wages", the Japanese worker would have earned more than an American worker as early as 1978. E. Vogel, *Japan as Number One: Lessons for America*, at 15 (1979).

These two substantial differences in methods of compensation make the "wage" factor in the standard three-factor formula impossible to calculate. Coupled with fluctuating currency exchange values, assigning the proper value to the wage factor for Japan alone would be an accountant's nightmare. When one considers that most foreign countries have economic and accounting customs different from those in the United States, the reliability of a simplistic three-factor formula in apportioning income is destroyed. Further, these differences make each foreign country economically distinct from the United States.

General economic differences among the nations eliminate the possibility of a rational relationship between income earned abroad and activities conducted within a state. Individual corporations also possess unique characteristics which undermine the rationality of using an apportionment formula. The Coca-Cola Company has two such characteristics.

The first is the unique position sugar occupies in the business of The Coca-Cola Company. The influence of sugar costs on the pricing

structure contributes to distortion in the sales factor when apportioning income of The Coca-Cola Company. Sugar exercises this influence because a different product is sold overseas from that sold in the United States. Abroad, The Coca-Cola Export Corporation, a subsidiary of The Coca-Cola Company, manufactures and sells concentrate (the beverage formula without sugar or water). Shipping concentrate is far easier and cheaper than shipping bulkier syrup. At home, Coca-Cola USA, a division of The Coca-Cola Company, sells syrup (the beverage formula with sugar and water).

Another unique characteristic of The Coca-Cola Company's business is the company's relationship with United States bottlers. In 1921, a contract between The Coca-Cola Company and United States bottlers froze the price of syrup. Until recently, the only price adjustment allowed has been an increase to cover escalating sugar costs. The United States District Court for the District of Delaware perpetualized this contract by a consent decree. As a result, the unit price of a gallon equivalent of product is much higher in the United States than in foreign countries. The cost of sugar is largely responsible for the price difference.

Sugar inflates not only domestic sales, but also property and payroll. Warehouses and equipment are needed for storing and shipping sugar, which is used in huge bulks. Delivering a bulkier product requires additional equipment and increases delivery costs. Additional personnel are necessary to handle sugar.

By increasing sales, property, and payroll figures, sugar contributes to distorting international income distribution. Overseas sales, property, and payroll factors are lower because no reckoning with sugar is required. Even though domestic income is lower than overseas income, individual states tax more income than was earned in the United States because domestic factors, inflated by an element not present overseas, attribute that income to state tax jurisdictions.

National economic differences and individual corporate characteristics distort the distribution of income through formulary apportionment. Still another fact adds to the distortion. Generally, a corporation's rate of return is higher abroad than domestically. Corporations expect a higher rate of profitability abroad because

business risks are higher in foreign countries, especially when the country is politically unstable. Both these facts are reflected in The Coca-Cola Company's experience abroad, as shown by the following chart:

THE COCA-COLA COMPANY AND SUBSIDIARIES
COMPARISON OF THE
RELATIONSHIP BETWEEN DOLLARS OF
SALES, PAYROLL, AND PROPERTY

Amount Required to Produce $1.00 of Net Income

		Sales	Payroll	Property (Cost)
1975	Domestic	9.94	.93	4.29
	Foreign	4.38	.55	1.80
1976	Domestic	8.96	.88	4.07
	Foreign	4.56	.57	1.85
1977	Domestic	9.52	.97	4.63
	Foreign	4.53	.53	1.80
1978	Domestic	11.90	1.18	5.79
	Foreign	4.57	.52	1.67

As the chart reveals, producing a dollar of income requires, for the most part, twice the sales, payroll and property in the United States as in foreign markets. In 1978, three times the property was required. The rate of profitability is much higher abroad. The high domestic factors used in an apportionment formula, unadjusted for rates of profitability, provide the states with much more taxable income than was earned within the borders of the United States.

Economic and business differences which characterize the world market defeat formulary apportionment as a fair method for taxing worldwide income. This Court has recognized that differences in operational costs and rates of profitability, if adequately proved, could defeat a state's apportionment ratio when taxing only domestic

income. *Norfolk & Western Railway Co.* v. *North Carolina*, 297 U.S. 682 at 686 (1936). When taxing worldwide income, these differences cause distortions so serious that any apportionment is unconstitutional.

A formula which requires economic consistency for its effective operation cannot produce a constitutional tax when it is stuffed with figures contrived from an inconsistent world market. This Court has broadly interpreted states' powers in matters of domestic taxation. In *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435 at 444 (1940), this Court said:

> "A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society."

When attributing to itself income earned in the United States, a state's apportionment formula need only roughly approximate the income related to activities within its borders. *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267 at 273 (1978). Such an approach is acceptable when dealing with the United States alone because each state by its own orderly government contributes to the orderliness of the United States as a whole and, thereby, to a business' ability to operate successfully. "Rough approximation," however, is an insufficient standard when a state attempts to tax worldwide operations. The orderliness of the marketplace in California or Kansas contributes nothing to a corporation's ability to earn a profit in Germany or Japan. More stringent standards are necessary because differences in currency values and wages do not even out over time. And, perhaps most important, stringent standards are necessary because no foreign country will accept a state's encroachment into that country's tax jurisdiction or a state's imposition of an increased tax burden on one of its corporations without retaliation.

Worldwide unitary taxation violates a taxpayer's right to due process guaranteed by the Fourteenth Amendment because it incor-

porates a formula which distorts the amount of income attributable to a taxing state. This distortion occurs because the formula treats economically distinct nations as though they are extensions of the American market place. Because foreign nations are economically distinct units and because apportionment formulas greatly distort income attribution, states imposing worldwide formulary apportionment tax income which bears no relationship to the taxpayer's intrastate activites.

Commerce Clause

Worldwide unitary taxation not only violates the Due Process Clause of the Fourteenth Amendment, but also impinges on Congress' power to regulate foreign commerce. A state statute which affects foreign commerce must meet two criteria in addition to the usual tests when determining the constitutionality of a state tax pursuant to the Commerce Clause. When foreign matters are involved, a state may not: (1) enhance the risk of multiple taxation, and (2) prevent a unified Federal approach in commercial dealings with other nations. *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446-448 (1979). States' practice of worldwide unitary taxation violates both these criteria.

First, worldwide unitary taxation is unconstitutional according to the Commerce Clause because this practice creates international multiple taxation. When a state uses worldwide unitary taxation, it includes in a taxpayer's income all income earned abroad before taxes; states do not allow credits for foreign taxes paid. This practice creates multiple taxation because foreign countries subject all income earned within their borders to taxation. A state, through worldwide unitary taxation, taxes this income again, even though in many instances the United States taxpayer was unable to repatriate all the income over which a state asserts jurisdiction. For example, in Colombia, a foreign corporation is restricted from remitting as dividends more than 20% of that corporation's registered foreign investment in Colombia. Int'l. Bur. of Fiscal Documentation, *Corporate Taxation in Latin America*, Section D, Andean Group Decision No. 24, Art. 37. A percentage of a corporation's income is effectively

blocked from repatriation, obviously to encourage a reinvestment of the blocked currency in Colombia.

The following chart shows, for The Coca-Cola Company, how much income earned in Germany was made available for duplicative taxation on one state's actual audit basis:

THE COCA-COLA COMPANY AND SUBSIDIARIES
COMPARISON OF PERCENTAGE OF INCOME APPORTIONED TO GERMANY AND SUBSIDIARIES ON ACTUAL AUDIT BASIS AND PERCENTAGE OF INCOME ON WHICH TAX WAS PAID TO GERMANY

Income Year	Percent of Germany Income on Which Foreign Income Tax Paid	Percent of Income Apportioned to Germany per Audit Basis	Percent of Total Germany Income Assigned to U.S. Locations
1967	100%	43.5%	56.5%
1968	100%	44.5%	55.5%
1969	100%	35.5%	64.5%
1970	100%	35.3%	64.7%
1971	100%	33.9%	66.1%
1972	100%	38.8%	61.2%
1973	100%	40.2%	59.8%
1974	100%	32.1%	67.9%
Total 1967-74	100%	37.0%	63.0%

For this eight-year period, the State has subjected to taxation 63% of income earned in and already taxed by Germany. Double taxation of foreign income is actual.

This Court has held that even a risk of multiple taxation provides sufficient grounds for overruling a state tax when foreign commerce is involved. *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 at 448 (1979). When imposing worldwide unitary taxation, the states have created more than a risk of multiple taxation — the states have made multiple taxation a reality. Foreign sovereigns have exercised their rights with respect to the income involved. The full value of income earned abroad has been subjected to another country's income tax. The facts now before the Court surpass the mere risk which invalidated the property tax in *Japan Line*, 441 U.S. at 448. Actual multiple taxation exists because a governmental entity over which this court has no authority has exercised its rights. No apportionment formula renders worldwide unitary taxation constitutional because worldwide unitary taxation subjects foreign commerce to a tax burden domestic commerce does not bear. Interstate apportionment simply cannot guarantee the absence of multiple tax burdens when foreign sovereigns are involved.

The lack of a forum for relief, which this Court recognized as a problem with respect to property taxes, also afflicts income taxes when worldwide unitary taxation is imposed. Among the nations, a system for relief of double taxation has been created by treaty. Relief from double taxation is incorporated in most United States tax conventions by a Mutual Agreement Procedure. Through this procedure, both countries agree to resolve taxation problems arising from government actions contrary to the convention. An official body, the competent authority, is appointed in each country to hear complaints arising pursuant to tax conventions. If necessary, the competent authorities of both countries attempt to negotiate a resolution of the problem. In the United States, this procedure is formalized in *Rev. Proc.* 65-17, 1965-1 C.B. 833 and *Rev. Proc.* 70-18, 1970-2 C.B. 493. Individual states of the United States are not parties to the conventions or the Mutual Agreement Procedure. Taxpayers suffering international double taxation resulting from the imposition of taxes by both a foreign sovereign and a state have no recourse to obtain the kind of relief available in tax treaties. If this Court does not invalidate worldwide unitary taxa-

tion as it invalidated the property tax in *Japan Line, Ltd.*, 441 U.S. 434, all the evils foreseen in *Japan Line* will materialize.

Among those evils is the international frustration created because worldwide unitary taxation also violates the second *Japan Line* criterion for constitutionality: a state tax cannot prevent the Federal Government from speaking with a unified voice in foreign matters. That worldwide unitary taxation has caused international frustration is made clear by negotiations over the Third Protocol amending a convention between the United States and Great Britain signed December 31, 1975. That amendment proposed the exclusion from state tax jurisdiction of income earned by corporations residing in Great Britain and related to corporations in the United States. The Department of State issued a report on the Third Protocol specifically indicting state taxation of foreign source income:

> "* * * This limitation is directed at the practice of a few States which are attempting to take into account the income on a consolidated basis of all related foreign enterprises in assessing the State income tax of a single member of the related group doing business in the State. This method of assessment, which includes the burden of producing worldwide records of all of the affiliated companies, has raised many objections by our treaty partners and we are now seeking to deal specifically with this problem in our treaties."
>
> (2 Tax Treaties (CCH) ¶ 8103DC)

Although the treaty was approved without the state tax limitation, British displeasure with worldwide combination has not ended.

The treaty, without its state tax limitation, was again recently discussed in Parliament. Mr. Michael Grylls, a Member of Parliament, noted the failure of the United States government to deliver a statutory prohibition of worldwide unitary taxation — an action promised in return for approving the above-discussed treaty. Mr. Grylls asserted that the Federal Government should not relinquish to the states the Federal prerogative in determining international

economic policy. Mr. Grylls then urged retaliatory taxation in the following language:

> "Where does that leave us? Parliament has been patient since 1975. This short debate gives us the opportunity to make it crystal clear to the United States Government that we cannot continue to accept the use of combined worldwide reporting systems by individual States, while the United States Government have agreed in over 40 treaties not to use it. We are not alone in our opposition. Recently there have been treaties between the United States and France and Canada. The European Community on behalf of its member States has presented two successive demarches to the United States Government seeking a solution to the problem.
>
> We have been patient because we are dealing with friends. We took our friends on trust. Unfortunately, in this instance our friends have not delivered. The only thing left to the British House of Commons — there will be increasing pressure on us to do this — is for us to take our own legislative action to apply a combined world-wide reporting system to United States companies that operate in Britain."
>
> *Brit. Firms Overseas* (Taxation), Apr. 27, 1982, at 825.

Objections to worldwide unitary taxation have also been raised by the Confederation of British Industry. Mr. Bryan Rigby, Deputy Director-General condemned worldwide unitary taxation as follows:

> "We have always argued that unitary taxation is a particularly obnoxious levy. It means some companies will be taxed twice for the same operation. At least 50 British companies with household names — including British American Tobacco, Cadbury Schweppes, Imperial Chemical Industries, Reckett & Coleman, and Unilever — are involved, as well as dozens of French, German, Italian, Dutch and other European multinationals."
>
> (Ins. for Int'l Research, *The Eur. and Middle East Tax Rep.*, April 16, 1982, at 1, col. 2.)

Although the international outcry against worldwide unitary taxation may be silenced by limiting its use only against domestic

parents, such a decision would violate the Equal Protection Clause of the Fourteenth Amendment. Even though the equal protection guarantee binds states to "no iron rule of equality" when exercising their taxing power, *Allied Stores of Ohio* v. *Bowers*, 358 U.S. 522 at 526 (1959), state taxing power is not limitless. Classifications must be reasonable and must fairly and substantially relate to a legitimate state goal. All persons similarly situated must be treated alike. *Allied Stores of Ohio*, 358 U.S. at 527; *Royster Guano Co.* v. *Virginia*, 253 U.S. 412 at 415 (1920).

Limiting the application of worldwide unitary taxation would cause unequal treatment of corporate citizens similarly situated. Two corporations engaged in the same business, operating in the same state, and organized under the same laws would bear unequal tax burdens solely because one would have a foreign parent. This Court has never sanctioned lineal descendency as a rational basis for unequal treatment. Such a classification is inherently arbitrary.

In addition, such classification bears no rational relationship to a legitimate state goal. A tax system which places a domestically headquartered corporation at a competitive disadvantage is completely irrational. Import tariffs are frequently imposed to protect domestic industry. Allowing states to impose higher tax burdens on a domestically pedigreed corporation directly conflicts with the Federal policy of protecting homegrown industry. A state can serve no legitimate end by alleviating the state tax burdens of foreign-based industry at the expense of domestic industry.

The imposition of worldwide unitary taxation violates the Commerce Clause because actual multiple taxation at the international level is precipitated. This Court has acknowledged its lack of power to ensure fair apportionment when the taxing power of a foreign sovereign is an element contributing to multiple taxation. The creation of multiple taxation and the lack of a competent forum to obtain relief are sufficient grounds for invalidating worldwide unitary taxation. Further, worldwide unitary taxation prevents the Federal government from speaking with one voice in international commercial policy. Foreign countries cannot accept the word of the Federal government in tax treaty negotiations because states, through

worldwide unitary taxation, subvert commercial policies to which the Federal government has agreed. Exempting foreign based industry from worldwide unitary taxation is unacceptable because equal protection guarantees would be violated. The only practical solution is eliminating the worldwide unitary method as a legitimate means of taxation.

CONCLUSION

For all the foregoing reasons, The Coca-Cola Company urges this Court to reverse the California Court of Appeal by declaring the Container Corporation of America to be a nonunitary business and by holding unconstitutional the worldwide unitary method of state income taxation.

Respectfully submitted,

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

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BRIEF OF COLGATE-PALMOLIVE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

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QUESTIONS PRESENTED

Whether requiring the income of foreign subsidiaries of a domestic corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the Foreign Commerce and Due Process Clauses of the United States Constitution, and in conflict with well established federal tax policy, when:

1. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries; and

2. The inclusion of the foreign subsidiaries' income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and double taxation of the foreign subsidiaries' income through misattribution of that income to California.

TABLE OF CONTENTS

	Page
INTEREST OF *AMICUS CURIAE*	1
SUMMARY OF ARGUMENT	2
ARGUMENT	
California's Use of Formulary Apportionment on a Worldwide Combination Basis Violates the Due Process Clause	3
A. Introduction	3
1. Extraterritorial Taxation Test	4
2. Unitary Business Income Test	5
B. California Is Attempting to Tax Extraterritorial Values	8
CONCLUSION	16

TABLE OF AUTHORITIES

CASES: Page

ASARCO, Inc. v. *Idaho State Tax Comm'n.*, ___ U.S. ___ (decided June 29, 1982) 6, 7, 7, n.6

Bass, Ratcliff & Gretton v. *State Tax Commission*, 266 U.S. 271 (1924) 5

Butler Bros. v. *McColgan*, 315 U.S. 501 (1942) 4, 6, 9, 11, 12, 13, 13, n.12; 14

Chicago Bridge & Iron Company v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al., prob. juris. noted*, ___ U.S. ___, No. 81-349 ..... 3, n.2

Exxon Corp. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) 6, 7, 13, n.12; 14

F. W. Woolworth Co. v. *Taxation & Rev. Dept.*, ___ U.S. ___ (decided June 29, 1982) 6, 7, 7, n.6

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U.S. Const. amend. XIV, § 1 ..... 3, n.2; *passim*

Table of Authorities Continued

Page

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Income Tax Convention between the United States and the Federal Republic of Germany, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920, Article III(2) 13, n.12

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On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF COLGATE-PALMOLIVE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT[1]

INTEREST OF *AMICUS CURIAE*

Amicus, Colgate-Palmolive Company, is engaged primarily in the worldwide production and distribution of household, personal care, and industrial products. *Amicus'* subsidiaries conduct operations in more than 50 foreign countries throughout the world. These foreign operations are substantial. In 1981, for example, they generated revenues of $3.1 billion and accounted for 58.7 percent of the total revenues reported by *amicus* in its

[1] Appellant and appellee have filed letters with the Clerk of this Court consenting generally to the filing of *amicus curiae* briefs in this case.

consolidated financial statements. See *Special Report: Spotlight on International Business*, Forbes, July 5, 1982, at p. 127.

This case is important to *amicus* because *amicus* is confronted with precisely the same issues in California (and in other States) as are presented here. California seeks to tax *amicus* on a worldwide combination basis despite documentary evidence submitted by *amicus* showing that (1) its subsidiaries operating in foreign countries are "discrete business enterprises" not functionally integrated with *amicus*' domestic operations, and (2) the inclusion of the foreign operations in the apportionment calculation results in significant over-attribution of income to California, as well as international multiple taxation.

SUMMARY OF ARGUMENT

Under recent decisions of this Court, California's use of a worldwide apportionment method to determine appellant's California tax liability is a clear violation of due process because appellant and its foreign subsidiaries are not engaged in a "unitary business."

Moreover, even if the operations of appellant and its foreign subsidiaries were viewed as a unitary business, ratable apportionment of their combined income would still be a violation of due process because appellant has established that its foreign subsidiaries' operations were significantly more productive than its domestic operations. Formulary apportionment is predicated on the assumption that each dollar of payroll, property, and sales in the taxing State will generate approximately the same amount of income as each dollar of payroll, property, and sales elsewhere. Where, as here, the taxpayer

demonstrates that its output per dollar of labor cost, property investment, or sales is much greater in foreign countries than it is in the United States, the assumption is no longer valid. In such a case, formulary apportionment will have the impermissible effect of shifting income from the more productive foreign operations to the less productive domestic operations, because formulary apportionment treats *all* of the operations as being *equally* productive.

Because California's apportionment formula does not reflect proven differences in productivity here and abroad, California's taxing structure violates due process by taxing appellant on extraterritorial values that have already been taxed once by the foreign countries in which appellant's subsidiaries conduct their business.[2]

ARGUMENT

CALIFORNIA'S USE OF FORMULARY APPORTIONMENT ON A WORLDWIDE COMBINATION BASIS VIOLATES THE DUE PROCESS CLAUSE

A. *Introduction*

This case tests the constitutionality of California's use of formulary apportionment on a worldwide combination basis (the "Worldwide Combination Method") to deter-

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[2] For the reasons set forth in the Jurisdictional Statement in this case, and the briefs previously filed by the appellant and the United States in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al., prob. juris. noted,* ___ U.S. ___, No. 81-349, California's apportionment method is also a *per se* violation of the Foreign Commerce Clause. The balance of this brief will be devoted to a discussion of issues arising under the Due Process Clause.

mine appellant's California taxable income.[3] Under the Due Process Clause, a nondomiciliary State's use of a formulary apportionment method must pass two tests:[4]

1. *Extraterritorial Taxation Test.* First, a nondomiciliary State may tax a resident corporation[5] only on that portion of the corporation's income that is attributable to the corporation's in-state activities. The nondomiciliary State may not tax "extraterritorial values." *Butler Bros.* v. *McColgan*, 315 U.S. 501, 507 (1942) (hereinafter "*Butler Bros.*").

Thus, in cases involving formulary apportionment, this Court has insisted that there be a "rational relationship between the income attributed to the State and the in-

---

[3] Under the Worldwide Combination Method, California, in effect, treated appellant and its foreign subsidiaries as a single corporation. That is, California (1) included all of the income of appellant and its foreign subsidiaries in apportionable income, (2) eliminated intercompany dividends from apportionable income, and (3) apportioned the combined income of the entire affiliated group to California on the basis of apportionment factors that took into account the payroll, property, and sales of appellant and its foreign subsidiaries.

[4] In addition to the two tests discussed in this brief, there must also be a "minimal connection" or "nexus" between the taxpayer's activities and the taxing State. *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980); *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435, 444-445 (1940). Appellant has agreed in this case that the requisite nexus is present.

[5] As used hereinafter, the term "resident" corporation means a corporation that is doing business within the taxing State, but is organized under the laws of some other State and has its headquarters or commercial domicile in some other State. In this case, appellant is a Delaware corporation with its headquarters in Illinois. (J.A. 6-7) All "J.A." references are to the separately bound Joint Appendix; all "J.S." references are to the Jurisdictional Statement; and all "J.S. App." references are to the appendices thereto.

trastate values of the enterprise." *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980) (hereinafter "*Mobil*"). See also *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 272 (1978), and *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 325 (1968). Where, however, the formula employed by the taxing State attributes to the State "a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state," the result will not be upheld. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931). The income attributed to the taxing State in such a case is "in no just sense attributable to transactions within" the State (*id.* at 134), and the apportionment method represents nothing more than "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271, 283 (1924).

2. *Unitary Business Income Test.* When a resident corporation conducts a functionally integrated, unitary business both within and without the taxing State, it is difficult to determine the amount of the corporation's income that is generated by the corporation's in-state activities. As this Court noted in *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920), the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Accordingly, in cases involving a unitary business, this Court has upheld the use of formulary apportionment (rather than separate accounting) to determine the income subject to tax by the nondomiciliary State. As this Court first stated in *Mobil*, 445 U.S. at 439:

> [T]he linchpin of apportionability in the field of state taxation is the unitary-business principle.

By comparison, income earned "in the course of activities unrelated to the" activities conducted in the taxing State (*i.e.*, income earned by a "discrete business enterprise") may not be taxed. *Mobil*, 445 U.S. at 439. Compare, in this regard, *Mobil; Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) (hereinafter "*Exxon*"), and *Butler Bros.* (where the income in issue was earned in the course of the taxpayers' unitary businesses, and was, therefore, apportionable) with *ASARCO, Inc.* v. *Idaho State Tax Comm'n.*, ___ U.S. ___ (decided June 29, 1982) (hereinafter "*ASARCO*"), and *F. W. Woolworth Co.* v. *Taxation & Rev. Dept.*, ___ U.S. ___ (decided June 29, 1982) (hereinafter "*Woolworth*") (where the income in issue was not earned in the course of the taxpayers' unitary businesses, and, therefore, was not apportionable).

Appellant claims in this case (J.S. 15-23) that California's use of the Worldwide Combination Method violates both of these due process tests. Insofar as the "unitary business income" test is concerned, appellant asserts that the operations of its foreign subsidiaries constitute "discrete business enterprise[s]" (*Mobil*, 445 U.S. at 439) whose income may not be included in apportionable income. A full analysis of the facts in this case is beyond the scope of this brief. *Amicus* does contend, however, that it is apparent from the opinion below that the California Court of Appeal employed an erroneous legal standard in applying the "unitary business income" test.[6] The unitary

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[6] For example, the Court of Appeal attached no significance to the important fact that there was no "substantial flow of goods" between appellant and its subsidiaries. (See J.S. App. A-14, A-15, A-20.) At the same time, the court attached undue significance to the fact that

business test should now be correctly applied by this Court under the standards laid down in its opinions in *Mobil*, *Exxon*, *ASARCO* and *Woolworth*.

When the proper legal standards are applied, *amicus* believes that appellant will be held not to be engaged in a unitary business with its foreign subsidiaries. However, even if appellant and its foreign subsidiaries were engaged in a unitary business, California's use of the Worldwide Combination Method in this case would still violate the extraterritorial taxation test. For the reasons discussed in Part B, California's use of the Worldwide Combination Method (which takes into account the operations of appellant's foreign subsidiaries) violates this test by attributing an unconstitutionally excessive amount of income to California. The standard three-factor formula cannot work under these circumstances and results in the attribution to California of an amount that is "out of all appropriate proportion to the business transacted by the appellant in" California. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135.

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appellant and its foreign subsidiaries were engaged in the same type of business, stating (J.S. App. A-15 - A-16):

> Appellant engaged in the same business activities as its subsidiaries. The administrative regulations indicate that a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business. This administrative construction of the California tax laws 'is entitled to great weight, and the courts generally will not depart from [that] construction unless it is clearly erroneous or unauthorized.' [Footnote and citations deleted.]

In so stating, the Court of Appeal obviously applied a legal standard that cannot be squared with this Court's subsequent opinions in *ASARCO* and *Woolworth*.

B. *California Is Attempting to Tax Extraterritorial Values*

Under formulary apportionment, the total income of the unitary business is ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return" as is earned by the entire business collectively.[7] Thus, where, as here, the traditional three-factor apportionment formula is employed, the taxing State will receive the same amount of income for every dollar of payroll, property, and sales in the State as the entire unitary business earns, on the average, for every dollar of payroll, property, and sales in all locations.

Such a result is constitutionally permissible only if the productivity of the employees, property, and sales in the taxing State is, in fact, approximately equal to the average productivity of all employees, property, and sales throughout the diverse jurisdictions in which the unitary

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[7] This can be demonstrated mathematically. The basic apportionment formula, using a single payroll, property, and sales ("PPS") factor for simplicity, is:

$$\text{unitary income} \times \frac{\text{state PPS}}{\text{total PPS}} = \text{state income}$$

Mathematically, this is equivalent to:

$$\frac{\text{state PPS}}{\text{total PPS}} = \frac{\text{state income}}{\text{unitary income}}$$

The "rate of return" is the ratio of income to the payroll, property, and sales producing that income. The rate of return everywhere will be the same because the foregoing equation can be rewritten:

$$\frac{\text{state income}}{\text{state PPS}} = \frac{\text{unitary income}}{\text{total PPS}}$$

business is conducted. Formulary apportionment works in such a case because, under those circumstances, the factors utilized by the formula fairly measure "the relative contribution of the activities in the . . . [taxing State] to the production of the total unitary income." *Butler Bros.*, 315 U.S. at 509, quoting from the California Supreme Court opinion in that case.

By comparison, where the employees, property, and sales are significantly and consistently more productive in the taxing State than for the entire business as a whole, the formula will always under-attribute income to the State.[8] Conversely, where the employees, property, and sales are significantly and consistently less productive in the taxing State than they are for the entire business as a whole, the formula will always over-attribute income to the State. Such constant and significant over-attribution to the taxing State violates the "extraterritorial taxation" test. As this Court recognized in *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. at 327:

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the

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[8] It is for this reason that *taxpayers* have sought to utilize the Worldwide Combination Method in cases where the taxpayer's operations inside the taxing State are more productive than its operations elsewhere. See, *e.g.*, *Superior Oil Co.* v. *Franchise Tax Bd.*, 60 Cal.2d 406, 386 P.2d 33 (1963). In such a case, utilization of the average overall rate of return to compute the tax can substantially reduce the amount of tax liability that the taxpayer would otherwise have. The reason for this result is that the averaging mechanism attributes less taxable income to the taxing State than was actually earned there. The States which utilize the Worldwide Combination Method have presumably concluded that their revenue losses in such cases will be more than offset by their revenue gains in the more common cases described in the next sentence of the text.

> Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product.

Intolerable distortion results from applying California's Worldwide Combination Method. California seeks to include in its apportionment calculation the operations of appellant's 20 foreign subsidiaries in Western Europe and Latin America. (J.A. 14-15) Similarly, in its proceedings against *amicus*, California seeks to include in its apportionment calculation the operations of *amicus*' subsidiaries in more than 50 foreign countries throughout the world. Wage rates, property costs, market share, gross profit percentages, price controls, rates of inflation, currency fluctuations, and other economic factors affecting profitability vary widely from country to country. When business operations transcend economic and national boundaries, it should come as no surprise that the straightforward application of the standard three-factor formula (as called for under the Worldwide Combination Method) produces distortion and a gross misallocation of income. The formula attributes an *average* rate of return on payroll, property, and sales to *each* jurisdiction, whereas the true rate of return for a particular jurisdiction may be significantly larger or smaller, depending on the relative productivity of the employees, property, and sales in that jurisdiction.[9]

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[9] This point was discussed by Assistant Secretary John E. Chapoton in the Treasury Department's comments on a draft of the GAO report entitled "IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Corporations" (GGD-81-81, Sept. 30, 1981). The Treasury Department's letter of July 10,

The expert testimony in the present case singled out "lower payroll costs in foreign countries" as the "number one factor" contributing to higher foreign productivity.[10] *Amicus* agrees. For example, in administrative proceedings before the California Franchise Tax Board, *amicus* submitted documentary evidence showing that the 1973 labor cost per converted case of product averaged $.945 for products produced by *amicus* in the United States, but only $.372 for comparable products produced by its subsidiaries operating in foreign countries. Where foreign operations achieve much greater productivity per dollar of payroll than domestic operations, an apportionment formula like California's that treats each dollar of payroll as equally productive will inevitably attribute to the domestic taxing jurisdiction income that was actually earned abroad. This results in "extraterritorial values being taxed."[11] *Butler Bros.*, 315 U.S. at 507.

1981, which is reproduced in Appendix IX to the cited GAO report, states in this regard that:

> In terms of economic rationale, formula apportionment has little merit because a corporation could have an increased tax burden merely as a result of its affiliates becoming more profitable or as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income.

[10] J.A. 169. See also J.S. App. A-41 - A-42, which contains a chart entitled "Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries" for the years 1967-1969. As shown by the chart on J.S. App. A-43, and the expert testimony at J.A. 169, this difference in wage rates is not offset by greater productivity per man-hour in the United States.

[11] See also Hellerstein, J. and Hellerstein, W., *State and Local Taxation* (4th ed. 1978), in which the authors come to precisely the same conclusion, stating (p. 539):

> The underlying premise of formulary apportionment under the Massachusetts three-factor formula is that (using UDITPA as illustrative), by and large, every dollar of wages or property

In *Butler Bros.*, this Court stated, based on the facts of that case, that (315 U.S. at 509):

> We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors *may* properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business. [Emphasis supplied.]

Butler Bros., however, involved a domestic wholesale dry goods and general merchandise business with its home office in Chicago and wholesale distributing houses in seven States. The taxpayer in *Butler Bros.* made no attempt to show significant differences in the relative productivity of the employees, property, and sales in the jurisdictions where the business was conducted. The taxpayer simply attempted to prove its California taxable income through separate accounting. Here, however, appellant has shown that its business in California and the other States was far less productive than the businesses

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spent in one taxing jurisdiction, along with receipts from sales in the area, will produce the same amount of profit in all taxing jurisdictions. Wide disparities in unit labor or unit property costs between taxing jurisdictions tend to attribute to the high wage-property cost jurisdictions, such as the United States, income which is attributable to other jurisdictions. A margin of tolerance for disparities in wage and property costs has been found constitutionally acceptable in the operation of apportionment formulas, as applied to interstate business, in view of the judicial recognition that any method of division of income is at best an approximation. . . . But once the differences exceed any reasonable measure of tolerance, the application of the formula ought to be vulnerable to constitutional challenge, unless the State grants a variation from the standard formula under the relief provision of the statute. [Citations deleted.]

of its foreign subsidiaries. (J.S. 18-20) Consequently, the Worldwide Combination Method cannot "properly be deemed" in this case to measure the "relative contribution" of appellant's California activities. See *Butler Bros.*, 315 U.S. at 509. Under these circumstances, it is entirely appropriate to use the internationally accepted arm's-length separate accounting method as a means of measuring the difference in profitability attributable to the independently established difference in productivity.[12]

The opinion below does not come to grips with appellant's argument that failure to reflect differences in productivity causes constitutionally unacceptable distortion. In this regard, the Court of Appeal stated (J.S. App. A-20):

> Appellant asserts that the application of the apportionment formula to foreign subsidiaries fails to account for different wages, property costs and returns on sales. Appellant recognizes that there are variations in wages, property costs and returns on sales within the United States, but argues that the wholly different nature of the elements in foreign countries creates an unreasonable result. Variations in profitability within the United States have not

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[12] Such arm's-length separate accounting computations (as contrasted with the internal audit results at issue in *Butler Bros.* and *Exxon*) are required by the laws of the United States and the foreign countries involved, and also by treaties between the United States and many foreign countries. See, *e.g.*, Internal Revenue Code of 1954, section 482; section 1 of the Aussensteuergesetz (Federal Republic of Germany); Art. III(2) of the Income Tax Convention between the United States and the Federal Republic of Germany, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920. These separate accounting results are subject to review by the tax authorities in the countries involved (see, *e.g.*, J.A. 78) and because those authorities have competing interests, their findings cannot be lightly dismissed.

> precluded apportionment of income according to an appropriate formula. [*John Deere Plow Co.* v. *Franchise Tax Bd.*, 38 Cal.2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952)] Where a company is engaged in a unitary business, a state may apply an apportionment formula to the taxpayer's total income to arrive at a rough approximation of the corporate income attributable to activities within the state. [*Exxon*, 447 U.S. at 223; *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 273]

Because the court made no effort to evaluate the degree of distortion in this case, its statement constitutes a categorical rejection, as a matter of law, of appellant's productivity argument—regardless of how aggravated the resulting distortion may be—and is grounds for reversal by this Court.

Amicus disagrees with the reasoning and the result in *John Deere Plow Co.* v. *Franchise Tax Bd.*, 38 Cal.2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952). Moreover, that case, like *Butler Bros.*, involved a business conducted wholly within the United States. The acceptance of the three-factor formula in such wholly domestic cases cannot properly be parlayed into a blanket, automatic acceptance of the formula in all cases—especially those where the asserted unitary business also is conducted, in part, in many different foreign countries with widely different economies. In such cases, economic conditions (such as labor rates, inflation rates, currency fluctuations and the like) will generally vary more widely than they will in a wholly domestic context. Accordingly, there is a far greater risk that the three-factor formula will over-attribute income to the United States by a significant amount. The consequences of such distortion are particularly severe, and the Due Process Clause prohibition on extraterritorial taxation should therefore be enforced with particular vigor, where, as here (J.S. 10-11),

the State is seeking to use formulary apportionment as a means of taxing income that has demonstrably been taxed abroad. *Cf. Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446-451, 455-456 (1979).

Amicus recognizes that precision is impossible when formulary apportionment is utilized to determine the amount of income attributable to activities in the taxing State. See *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 273. Obviously, some divergence is to be expected between the actual productivity in the taxing State and the average productivity of the entire unitary business. Nevertheless, despite the constitutional acceptability of occasional over-reflection or under-reflection of income, this Court also reiterated in *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 274, that a "formula-produced assessment" will not be permitted—

> when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that State,' [*Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135], or has 'led to a grossly distorted result,' [*Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. at 326].

This is such a case.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below. If, however, this Court upholds the constitutionality of California's Worldwide Combination Method as applied to the facts of this case, *amicus* respectfully requests that the Court state in its opinion that the Worldwide Combination Method will, nonetheless, be held unconstitutional if (1) the taxpayer is not conducting a functionally integrated, unitary business with its foreign affiliates, or (2) the use of the Worldwide Combination Method results in significant distortion and the over-attribution of income to the taxing State.

Respectfully submitted,

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal From The Court Of Appeal Of California, First Appellate District

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

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TABLE OF CONTENTS

	Page
INTRODUCTORY STATEMENT	1
OPINIONS BELOW	1
INTEREST OF *AMICUS CURIAE*	2
SUMMARY OF ARGUMENT	4
ARGUMENT	6
DUE PROCESS	6
Container's Foreign Subsidiaries Are "Discrete Business Enterprises" And Taxation Of Their Income By California Contravenes Due Process	6
Application Of Worldwide Formula Apportionment Results In Such Gross Distortion As To Violate Due Process	13
COMMERCE CLAUSE	15
Worldwide Combined Apportionment Inherently Creates International Multiple Taxation	17
One Voice Should Regulate Foreign Commerce	21
CONCLUSION	27

TABLE OF AUTHORITIES

CASES: Page

ASARCO, Inc. v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (June 29, 1982) 4, 9, 11

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U.S. 271 (1924) 3, 8

Butler Bros. v. *McColgan*, 315 U.S. 501 (1942) 8, 13

Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977) 16

Evco v. *Jones*, 409 U.S. 91 (1972) 17

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) 8, 9

F.W. Woolworth Co. v. *Taxation and Revenue Department of New Mexico*, 50 U.S.L.W. 4957 (June 29, 1982) . 4, 9, 10

Hans Rees' Sons v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931) 13, 15

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 16, 17, 18, 24, 25

McDonnell Douglas Corp. v. *Franchise Tax Board*, 69 Cal. 2d 506, 446 P.2d 313 (1968) 13

Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980) 3, 8, 9, 13

Moorman Mfg. Co. v. *Bair*, 437 U.S. 267 (1978) 8

Norfolk & Western Railway Co. v. *Missouri State Tax Commission*, 390 U.S. 317 (1968) 15

Standard Oil Company v. *Peck*, 342 U.S. 382 (1952) 17

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 8, 15

U.S. Steel Corp. v. *Multistate Tax Commission*, 434 U.S. 452 (1977) 23, 25, n.16

Zee Toys, Inc. v. *County of Los Angeles*, 85 Cal. App. 3d 763 (1978), *aff'd sub nom. Sears, Roebuck & Company of Los Angeles*, 449 U.S. 1119 (1981) 21, n.6

CONSTITUTION:

U.S. CONST. art. I, sect 8, cl. 3 ..... 3, *passim*

U.S. CONST. amend. XIV, sect. 1 ..... 3, *passim*

Table of Authorities Continued

Page

STATUTES AND REGULATIONS:

Internal Revenue Code of 1954, as amended (26 U.S.C. sect. 482) 25

Pub. L. No. 86-272, 73 Stat. 555 (1959) 25

Treas. Reg. sect. 1.482-1(b) 18

OTHER AUTHORITIES:

A.B. 525, Cal. Legislature, Regular Session 1979-1980 23, n.10

Comp. Gen. Report to the Chairman, House Comm. on Ways and Means, app. IX (September 30, 1981) 14, 22, 23

Hansard, British Firms Overseas (Taxation) (April 27, 1982) 24

H.B. 2588, Ill. Legislature, Regular Session 1981-1982 23, n.11

Income Tax Convention, April 27, 1932, United States-France, art. IV, 49 Stat. 3145, T.S. No. 885 21

Jurisdictional Statement, *Container Corporation of America* v. *Franchise Tax Board*, No. 81-523, *prob. juris. noted*, May 3, 1982 ..... 18, 19,20, 21

Report of the Department of State to the President (June 8, 1976) CCH Tax Treaties para. 8103 EE 23

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d. Sess. (1980) 22, 24

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United States Model Income Tax Treaty, 41 Fed. Reg. 20427 (1976) 22

United States Model Income Tax Treaty, 46 Fed. Reg, 37432 (1981) 22

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as *amicus curiae* in support of the Appellant in the above-captioned case. Written consents of Appellant and Appellee have been obtained and are attached herewith.

OPINIONS BELOW

The Opinion of the Court of Appeal of California, First Appellate District, is reported at 117 Cal. App. 3rd 988, 173 Cal. Rptr. 121 (1981); the memorandum opinion and judgment of the California Superior Court are not reported.

INTEREST OF AMICUS CURIAE

The Council of State Chambers of Commerce (COUNCIL), organized in 1932, consists of 34 Chambers of Commerce. The Committee on State Taxation (COST), one of the three advisory committees of the COUNCIL, consists of 187 corporate members which conduct a substantial portion of the interstate and foreign commerce of United States taxpayers. One of COST's principal activities has been to work with the states and others toward developing fair and equitable standards in the income allocation and apportionment aspects of state taxation.

Member companies of COST are representative of that part of the Nation's business sector which is most directly affected by state taxation of interstate and foreign commerce operations. COST is, therefore, vitally interested in cases such as this one which present issues significantly affecting state and local taxation of interstate and foreign commerce.

This case involves the application by California of the "worldwide combination" formula to generate substantial additional revenues based upon the "combined" incomes of Appellant and its subsidiaries and affiliates. Unlike a similar case currently before this Court, *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, No. 81-349, (argued before this Court on April 19, 1982 and restored to the calendar on May 3, 1982 for rehearing during the next term), this case has a record establishing the absence of an underlying "unitary" relationship, and the existence of gross distortion. Unlike Caterpillar Tractor Company, the taxpayer herein is vigorously opposed to the "worldwide combination" formula.

From the constitutional viewpoint, COST is particularly interested in this case because the Appellant, Container Corporation of America, has presented the Court the following substantial question:

Whether California's application of its "worldwide combination" formula to a domestic corporation and its foreign subsidiaries, whereby the operations of all the members of the affiliated group are treated as a single profit-generating enterprise whose profit is assigned to California on the basis of the relative amounts of property, payroll and sales receipts of the affiliated group in California to property, payroll and sales receipts of the group worldwide, is repugnant to the due process and foreign commerce clauses of the federal constitution and in conflict with well-established federal tax policy when:

1. The foreign subsidiaries are not functionally integrated with the California taxpayer and there is no substantial flow of goods among them or between them and the domestic parent;

2. The formula used to assign income of the affiliated group to California results in a significantly greater amount of taxable income for California tax purposes than would otherwise be the case because of differences in the cost of capital goods, labor productivity, market forces and managerial efficiency in California and the foreign countries in which the foreign subsidiaries operate; and

3. The "worldwide combined" method followed by California taxes income also taxed by the foreign subsidiaries' domiciliary countries.

The Court has approved state taxation of a "classic" vertically-integrated, single company "unitary business" operating within a state and abroad if a fair apportionment is made. *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271, 282 (1924). In *Mobil Oil Corporation* v. *Commissioner of Taxes*, 445 U.S. 425, 439-440 (1980), the Court upheld Vermont's taxation of dividends received by a New York corporation from its non-United States subsidiaries after Mobil (1) failed to demonstrate that its dividend-paying subsidiaries were engaged in business activities unrelated to its "integrated petroleum business" and (2) did not dispute "the accuracy or fairness of Vermont's apportionment formula."

445 U.S. at 434. More recently, in *ASARCO, Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (June 29, 1982), and *F. W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, 50 U.S.L.W. 4957 (June 29, 1982), the Court rejected the states' taxation of dividends received by nondomiciliary parent corporations from their non-United States wholly or partly-owned subsidiaries after finding that, unlike Mobil, the taxpayers had succeeded in proving that the dividend-paying subsidiaries were "discrete business enterprises" and not part of "unitary businesses" conducted in the taxing states with the parent corporations.

The Court has never decided whether a state may, by means of a "worldwide combination" formula, tax the non-United States income of a taxpayer's subsidiaries operating in foreign countries, when the subsidiaries and the taxpayer are not functionally integrated and that income has already been taxed by foreign jurisdictions.

The decision of the Court of Appeal of California, sanctioning formula apportionment of the "worldwide combined" income of affiliated corporations for state income tax purposes, is repugnant to longstanding judicial interpretations by this Court of the due process and commerce clauses of the federal constitution. If it is not reversed, it will lead to international multiple taxation of multinational corporations and impair federal uniformity in an area where federal uniformity is essential.

SUMMARY OF ARGUMENT

A state's inclusion of income of subsidiaries operating outside the United States in the apportionable base under the circumstances of this case offends the Due Process Clause of the Fourteenth Amendment. It also violates the Commerce Clause because it (1) constitutes an unreasonable burden on foreign commerce and (2) is contrary to, and interferes with, the established tax policy of the United States.

Fundamental to a state's attempt to "combine" extraterritorial income is the "unitary business" relationship which must exist between the affiliated members of the combined group. This prerequisite is not met where the operations of foreign subsidiaries are not part of a functionally integrated business with the domestic parent corporation and no significant property is transferred between the parent and its foreign subsidiaries. It is not met in the case at hand.

The basic assumptions underlying the equitableness of the unitary system of taxation applied by California ("worldwide combination") are that the operations of individual units of a commonly-controlled group of corporations are so interrelated as to earn a profit only from transactions with others outside the group, and that property, labor and market forces will produce approximately the same rate of profit wherever the units are doing business. These assumptions can be shattered when such an apportionment formula is applied beyond the borders of the United States to "combined" companies operating in foreign countries. An arbitrary and distorted result is then produced as a result of the broad economic, political and social differences which exist between this country and most of the remainder of the world.

If the unitary system is to be applied to affiliated groups which include corporations doing business in foreign countries, it should be limited to those situations in which there is functional integration as demonstrated by a substantial flow of goods. In the context of "worldwide combined" reporting, this should be the definition of a "unitary business".

Alternatively, if "worldwide combined" reporting is sanctioned in situations where "unitary business" relationships exist, it should only be allowed when factor adjustments are made to bring into accord factors which are not comparable.

ARGUMENT

Due Process

Container's Foreign Subsidiaries Are "Discrete Business Enterprises" And Taxation Of Their Income By California Contravenes Due Process

This Court is being asked by the California Franchise Tax Board to sanction a system of reporting for state income tax purposes that considers the separate operations of affiliated corporations as though they are inseparable parts of a single profit-generating process. Accordingly, intercorporate transactions between members of the affiliated group are disregarded and income is recognized only with respect to transactions outside the group. This income is then apportioned to state taxing jurisdictions by the combined factors of the group. This apportionment procedure assigns a portion of the profit generated by the group to each taxing jurisdiction relative to the property, payroll and sales receipts of the group in that jurisdiction. No attempt is made to determine and tax the profit produced by the individual members in the taxing jurisdictions in which they operate.

The importance of restricting the definition of a "unitary business" in relation to taxpayers with subsidiaries doing business in foreign countries (or taxpayers having parent corporations in foreign countries) is attributable to the incompatibility of the separate entity arm's length method used by the principal trading partners of the United States and the unitary system of California. The unitary system imposed by California depends on the mechanism of an apportionment formula composed of property, payroll and sales receipts factors. The apportionment formula is relative. That is, the amount of income assigned to a particular taxing jurisdiction is a function of the relationship of the factors of the formula located in the taxing jurisdiction to the factors located elsewhere. For example, if a taxpayer earns a return of 10% on its property and labor located in State A and 15% on a like amount of property and labor in State B, for a total

profit of $10,000, the apportionment method will assign $5,000 to State A and $5,000 to State B based on the relation of the factors. This apportionment disregards the difference in profit rates from operations in the two states. On the other hand, under the arm's length method, if the operations in State A are conducted by Subsidiary A and those in State B by Subsidiary B, State A will impose its tax on $4,000 and State B on $6,000.

In other words, the unitary system is a relational concept while the separate entity arm's length method is a source concept. Seldom, if ever, will the two methods produce a similar result when applied to businesses conducted in foreign countries having quite different economic and social environments. The divergence of the two methods is significant when substantial differences in the profit rates among taxing jurisdictions are created by differences in the cost of capital goods, labor productivity, market forces and management efficiencies. The first three of these have a direct, but inverse, impact on the factors of the apportionment formula in relation to profit rates and the fourth is not reflected in the factors at all. As more fully developed hereinafter, higher factor costs in the United States and relatively lower profit margins as compared to those in foreign countries benefit states using the unitary system worldwide and greatly enhance the risk of multiple taxation of income earned by corporations abroad.

The underpinning of this combined reporting procedure is the "unitary" relationship that must exist between members of the group. The "unitary" doctrine had its origin in property and capital stock taxes applied by the states to railroad and telegraph companies. State income tax cases followed the principles of these earlier property and capital stock cases and defined a "unitary business" as one having a substantial transfer of products between intrastate and extrastate operations. This basic definition has continued to be predominant in cases involving manufacturing, producing and mercantile companies. *E.g.*,

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) (integrated petroleum business); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (integrated petroleum business); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978) (integrated manufacture and sale of animal feeds); *Butler Bros.* v. *McColgan*, 315 U.S. 501 (1942) (integrated wholesale business); *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271 (1924) (integrated manufacture and sale of ale); *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters).

The Court has historically sanctioned the use of the formula apportionment method to determine the income tax liability of a corporation doing business both inside and outside the state only if and to the extent that the income being apportioned is derived from a "unitary business" in which the activities being conducted outside the taxing state are functionally integrated with the activities being conducted inside the state. In all cases, functional integration has been evidenced by a substantial transfer of products.

In *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the Court enunciated the general principle underlying a state's apportionment and taxation of extraterritorial income, stating that "the linchpin of apportionability is the unitary business principle". 445 U.S. at 439. To avoid apportionment of dividend income, this Court explained that a taxpayer must show that the payor's income is earned in the course of activities unrelated to the business within the taxing State. In other words, to avoid apportionment, the taxpayer can show that the foreign operations of its subsidiaries and affiliates are distinct in a business or economic sense from its activities in a taxing state. There, Mobil failed to offer any evidence that its foreign subsidiaries were engaged in business activities unrelated to its "integrated petroleum business", 445 U.S. at 428, a part of which was conducted in the taxing state.

The "unitary business" principles of *Mobil* were reiterated shortly thereafter in *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980):

> "In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of the activities unrelated to the sale of petroleum products in that State.' . . . The court looks to the 'underlying economic realities of a unitary business,' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise,' 445 U.S., at 441, 442, 439." 447 U.S. at 223-224.

Upon examination of Exxon's organizational structure and business operations, the Court found that Exxon was "a highly integrated business which benefits from an umbrella of centralized management and controlled interaction". 447 U.S. at 224.

Most recently, in *ASARCO, Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (June 29, 1982), and *F. W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, 50 U.S.L.W. 4957 (June 29, 1982), the Court rejected the states' apportionment and taxation of dividends received by the nondomiciliary parent corporations from their non-United States subsidiaries after finding that, unlike Mobil and Exxon, each of the taxpayers had succeeded in proving that the dividend-paying subsidiaries were not part of its unitary business but rather were "discrete business enterprises", 50 U.S.L.W. at 4961, which in "any business or economic sense" had "nothing to do with the activities" of the parent corporation in the taxing state. 50 U.S.L.W. at 4968.

The Court, in *Woolworth*, spelled out the limitations of the "unitary business" principles stated in *Mobil*. The question relevant to a state's right to tax dividends from foreign subsidiaries is "whether 'contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale.' 445 U.S., at 438. If

such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State. *Ibid.*" *Woolworth*, 50 U.S.L.W. at 4959.

Upon finding that the essential factors did not exist to evidence an underlying "unitary business" between Woolworth and its foreign subsidiaries, the Court stated that "[t]here is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—in which refined, processed, or manufactured products [or parts thereof] may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense in which our cases consistently have used these terms." 50 U.S.L.W. at 4961.

That the absence of a flow of international business, a substantial transfer of common products, between the affiliated corporations was also critical in the *ASARCO* case can be discerned in the Court's footnoted response regarding the foundation of the "unitary business" principle, wherein it was stated:

> "As we recognize in the Court's opinion, these cases are decided on their facts in light of established general principles. The most comprehensive discussion of the factors that are relevant is contained in our recent decisions in *Mobil* and *Exxon*. In both of those cases, that we follow today, the *states prevailed because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products*. ASARCO has proved that these essential factors are whol-

> ly absent in this case. It is late in the day to confuse this important area of state tax law by rewriting the standards of *Mobil* and *Exxon*." (emphasis added) 50 U.S.L.W. at 4968, n. 24.

The Court has made it clear that, consistent with due process requirements, a substantial transfer of products or flow of goods between the taxpayer corporation and its subsidiaries and affiliates is integral to a finding that the corporate members of a combined group are engaged in a "unitary business". The absence of an ongoing interchange of common materials and products, as lacking in *ASARCO* and *Woolworth*, would compel the conclusion that a "unitary business" does not exist.

Here, the record shows that Appellant, Container Corporation of America (Container), and its foreign subsidiaries carried on their businesses separately and independently. The operations of the foreign subsidiaries were highly decentralized so that the subsidiaries located in each particular country operated as autonomous businesses, rarely crossing national borders. There was no significant flow of goods or transfer of products comparable to that in *Mobil* and *Exxon*. The involvement of Container management in decisions affecting the foreign subsidiaries was limited to decisions about appropriations involving major capital expenditures. Container provided its subsidiaries with little material assistance in developing technology and charged its foreign subsidiaries for all information provided. The foreign subsidiaries generally obtained financing from local sources. There were no substantial centralized services performed by Container for the subsidiaries or by the subsidiaries for each other or Container. In short, there was no functional integration, centralization of management or achievement of other economies of scale that would support the application of "combination" apportionment to Container and its foreign subsidiaries.

California relied upon Container's ownership of more than 50 percent of the voting stock of its foreign subsidiaries; the fact that the foreign subsidiaries were engaged in the same type of business as Container; and upon minor contacts and oversight responsibilities with respect to the subsidiaries, which, in the aggregate, were substantially less significant than the relationships between Woolworth and its subsidiaries, to support a "unitary business" finding for the purpose of applying its "worldwide combined" formula method to Container and its foreign subsidiaries. No attempt was made by California to explain how these activities of this Chicago-headquartered corporation caused it to allegedly understate its California taxable income. On the contrary, and as hereinafter set out, Container has amply demonstrated that the application of the "worldwide combined" formula method to it and its foreign subsidiaries operating in dissimilar economic and social environments has substantially overstated its California taxable income.

While *ASARCO* and *Woolworth* dealt with the taxation of a portion of intangible income received by a nondomiciliary parent corporation from subsidiary corporations having no other connection with the taxing state, the issue in this case is the constitutionality of including in the tax base of a nondomiciliary parent corporation the income of subsidiary corporations conducting discrete businesses in foreign countries and having no connection with the taxing state. In an economic or business sense, there is no basis for a state to combine the income and apportionment factors of subsidiary corporations doing business in foreign countries with the income and factors of the parent corporation doing business in the state in order to determine the parent corporation's taxable income when the subsidiary corporations are discrete businesses operating as autonomous entities.

California has applied its "worldwide combination" method in order to determine Container's taxable income despite the fact that the income of its foreign subsidiaries is unrelated to Container's business activities in California. The record herein shows that there was clearly no "unitary business" relationship between Container and its foreign subsidiaries. California's resort to this method is simply an effort to reach profits earned elsewhere. For this reason alone, California's attempt to impose "worldwide combination" herein should be rejected.

Application Of Worldwide Formula Apportionment Results In Such Gross Distortion As To Violate Due Process

Where a state seeks to impose a tax on income generated by interstate and intrastate activities, the Due Process Clause of the Fourteenth Amendment requires that there be at least a " 'minimal connection' between the interstate activities and the taxing state, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise". *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 437. If an apportionment formula results in the taxation of income out of all reasonable proportion to the corporation's business activities within the state, the formula violates the Due Process Clause. *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123 (1931); *McDonnell Douglas Corp.* v. *Franchise Tax Board*, 69 Cal. 2d 506, 446 P.2d 313 (1968).

Formula apportionment has long been accepted as reasonable when applied to a single multistate corporation within the homogenous states of the United States. *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942). However, it creates distortion and multiple taxation when applied to the "worldwide combined" income of multinational corporations. On July 10, 1981, John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, stated succinctly:

> "In terms of economic rationale, formula apportionment [in a "worldwide combined" context] has little merit because a corporation could have an increased tax burden

> merely as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a Taxpayer's income."[1]

Formula apportionment does not provide a fair measure when it is applied on a "worldwide combined" basis. In theory, this combined report is not a tax return but merely a device to arrive at a taxpayer's income derived from sources within the state. Also in theory, the combined report is not intended to tax one corporation's income as if it were the income of another corporation. In practice, however, the opposite result occurs. Income of the affiliated corporations is recast as the income of the jurisdictionally present corporation and then apportioned to the state without taking into account the essential elements responsible for the earning of the affiliates' income.

The experience of COST members shows that foreign wages are generally lower than U.S. wages and profits of foreign subsidiaries are generally higher. In many instances, foreign properties, such as oil wells in OPEC countries, are much more productive than U.S. properties and, therefore, substantially less foreign property may be required to produce the same amount of foreign income as produced domestically. Thus, the application of formula apportionment to "worldwide combined" income attributes a disproportionnate amount of income to the state applying formula apportionment to "worldwide combined" income.

Income taxes in many foreign countries are levied at much higher rates than in the United States. Since a "worldwide combined" state, which does not permit foreign income taxes to be deducted, has state taxable income (and consequently, the tax) which increases as foreign taxes increase, even though the

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[1] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 93 (September 30, 1981).

combined corporation's actual profit remains the same, a gross distortion in the amount of income attributed to the taxing state results. Accordingly, when an apportionment formula is applied on a "worldwide combination" basis, there is no rational relationship between the income attributed to the state and the intrastate values of the business enterprise.

The difficulties inherent in fairly apportioning income among the various states in which a business is conducted have long been recognized. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 120-121 (1920). If a taxpayer shows that "the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result", *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. at 121, or that the income attributed to the state was "out of all appropriate proportion to the business transacted . . . in that state", *Hans Rees' Sons* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135, or that the formula "led to a grossly distorted result", *Norfolk & Western Railway Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 326 (1968), then Due Process is violated. For all of these reasons, the "worldwide combined" method imposed by the California Franchise Tax Board violates Due Process in this case and in most cases of our other members.

The "worldwide combination" apportionment method thus creates a blatant violation of Due Process. Distortion in the apportionment factors not only results in extraterritorial income being apportioned to the states but also causes apportionment of a disproportionate amount of foreign income due to the disparity in property and payroll values. Consistent with constitutional principles and judicial precedents, this method should not be allowed.

Commerce Clause

Formula apportionment of "worldwide combined" income of affiliated corporations for state income tax purposes (a) creates

a substantial risk of international multiple taxation and (b) prevents the United States government from speaking with one voice in regulating commercial relations with foreign governments.

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979), sets forth the governing principles under the Commerce Clause. There, the Court reiterated the standard applicable to a tax on interstate commerce set out in *Complete Auto Transit Inc.* v. *Brady*, 430 U.S. 274, 279 (1977): "If the state tax 'is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State,' no impermissible burden on interstate commerce will be found." 441 U.S. at 444-445.

With respect to state taxation which impacts foreign commerce, the Court explained in *Japan Line* that two additional standards must be met (441 U.S. at 446, 448):

> "When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations beyond those articulated in *Complete Auto*, come into play. The first is the enhanced risk of multiple taxation.
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> "Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."

The Court then ruled that:

> "In addition to answering the nexus, apportionment and nondiscrimination questions . . ., a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'. If a state tax contravenes either of these precepts,

it is unconstitutional under the Commerce Clause." 441 U.S. at 451.

The rationale of *Japan Line* is fully applicable in the instant case. The constitutional limitations which apply to state taxing powers do not differentiate between different kinds of taxes. Taxes which result in multiple burdens on interstate or foreign commerce are invalid regardless of the kind of tax involved. *See, e.g., Evco* v. *Jones*, 409 U.S. 91 (1972); *Standard Oil Company* v. *Peck*, 342 U.S. 382 (1952). The gravamen of an invalid tax is its burden on commerce and not what it is called or to what asset it is applied.

Worldwide Combined Apportionment Inherently Creates International Multiple Taxation

Formula apportionment of "worldwide combined" income of affiliated corporations inherently creates a substantial risk of international multiple taxation. As stated by then Assistant Secretary of the Treasury, Laurence N. Woodworth:

> "Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation."[2]

Dr. Woodworth further noted:

> "[L]abor costs vary substantively among countries — very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong

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[2] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 34 (1977).

> Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California."[3]

Application of the apportionment formula method on a "worldwide combination" basis creates more than the inherent risk of multiple taxation. It *does* produce multiple taxation. Income of a foreign subsidiary is taxed by one or more foreign countries which employ the federally-accepted and internationally-accepted arm's length concept set forth in Federal Treasury Regulation section 1.482-1(b). By applying a state apportionment method on a "worldwide combination" basis, income which has already been fully taxed on an unapportioned basis in the foreign countries under the arm's length concept is attributed to the state under the apportionment formula. Thus, multiple taxation results because "neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign". *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. at 447.

In the case at hand, the prohibited international multiple taxation is generated by California's "worldwide combination" formula as set forth on pages 9, 10 and 11 of the Jurisdictional Statement filed with the Court on September 14, 1981 by the Appellant:

> "Double taxation results because the income of the foreign subsidiaries is taxed in their respective countries on an arm's-length basis, *i.e.*, the income earned by a particular subsidiary was taxed in its country of operation without reference to income of its domestic parent. Stip. ¶¶ 139-140. By contrast, California taxed the apportioned segment of the world-wide income, taking into account the same income (before foreign tax) of the foreign subsidiaries which have already been taxed in those foreign

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[3] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations,* 95th Cong., 1st Sess. 34 (1977).

countries. This results in a double tax burden on income from foreign commerce to which domestic commerce is not exposed.

"Double taxation can be illustrated by application of California's own apportionment formula. That is to say, if one applies the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being world-wide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by world-wide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:

1963	1964	1965
$2,407,000	$3,966,000	$5,466,000

"This double taxation is confirmed by a comparison of the income attributed to the various countries under an arm's-length analysis with that assigned to the countries by the use of California's apportionment formula. [4]

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[4] This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc.* v. *Franchise Tax Board*, 3 Cal. 3d 745, 754, 91 Cal. Rptr. 616, 621 (1970).

	Average Pre-Tax Income Per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
CCA (United States)...	$28,121	$32,068
Columbia.....	4,254	2,203
Mexico	1,605	1,430
Venezuela	4,246	1,907
Panama	1,286	—
Austria.....	(13)	11
Germany	1,793	2,906
Holland	384	197
Italy.....	34	968
Total Foreign	13,588	9,642
Total Combined	$41,710	$41,710

000's omitted — Sch. VI to Exh. 1, Stip. re Testimony, C.T. 289.

"Multiple taxation is illustrated from the fact that the apportionment formula attributes to other countries approximately one-half of the income produced in Columbia and Venezuela according to arms's-length principles applied to those countries. In Columbia's case, for example, this produces the ludicrous result of apportioning about the same pretax *income* to Columbia as the Colombian subsidiaries paid in Colombian income *taxes*. The *income* attributed to Colombia by the California formula for the years in question [illegible], respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be $2,508,036,

$2,533,755, and $1,484,104, respectively.[5] This is a severe dislocation of the tax base."

This international multiple taxation problem is further compounded when a "worldwide combination" state takes a fifty-one percent (or more) affiliate and includes one hundred percent of its income in the tax base.

One Voice Should Regulate Foreign Commerce

Many U.S. parent corporations conduct business only in the United States and have subsidiaries which do business abroad. Many foreign-parent corporations conduct no business in the United States and have subsidiaries which do business here.[6] In both cases, each of the related corporations (*i.e.*, domestic and foreign subsidiaries, parent corporation, brother-sister corporations) is treated as an independent entity operating on an arm's length basis for income tax purposes by the United States, by foreign countries and by most states.

The single entity arm's length concept was adopted in the first income tax convention to which the United States was a party, Income Tax Convention, April 27, 1932, United States-France, art. IV, 49 Stat. 3145, T.S. No. 885, and it has been the

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[5] Second Addendum to Stip. ¶ 159, C.T. 147-149. As a further example by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of $384,000 per year. The actual taxes paid to the Dutch government averaged 97 percent of the income attributed to Holland by the California formula. *Id.*

[6] Discriminatory treatment in favor of foreign-parent corporations with U.S. subsidiaries vis-a-vis U.S. parent corporations with foreign subsidiaries would, of course, be improper. *See Zee Toys, Inc.* v. *County of Los Angeles*, 85 Cal. App. 3d 763 (Ct. App. 1978), *aff'd by an equally divided court sub nom. Sears, Roebuck & Company of Los Angeles*, 449 U.S. 1119 (1981).

basis of *all* of our subsequent tax treaties. This approach is considered the "internationally accepted norm"[7] and it is incorporated in the model convention proposed by the Organization for Economic Cooperation and Development (OECD), of which the United States is a member.[8] This concept is also reflected in Articles 7 and 9 of the United States Model Income Tax Treaty, which the Department of Treasury announced on May 18, 1976 (41 Fed. Reg. 20427) and again most recently on July 20, 1981 (46 Fed. Reg. 37432).

The California Franchise Tax Board has substituted formula apportionment in a multicorporate context for the internationally-accepted arm's length concept. The Franchise Tax Board has made the substitution by extending the application of its three-factor apportionment formula (used for dividing the income of a single multistate corporation) to the "worldwide combined" income of a taxpayer and its affiliates operating abroad.

John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, reported on July 10, 1981 that formula apportionment is not widely used by the states in a multicorporate context. He stated that "it is, with very few exceptions, used by the states only to divide the income of a single multistate corporation, which is a totally different matter".[9] Mr. Chapo-

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[7] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[8] *State Taxation of Foreign Source Income: Hearings on H.R. 5076 before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 301 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[9] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 93 (September 30, 1981).

ton also noted that "some of the few states who use it, such as California, are considering abandoning it". [10]

Actually, formula apportionment of "worldwide combined" income in a multicorporate context is being aggressively pursued by Alaska, California, Colorado, Idaho, Montana and Oregon, all of which are members of the Multistate Tax Compact. *U.S. Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452, 454 n.1 (1977). Illinois Department of Revenue seeks to join this group through its "friendly" lawsuit currently before the Court. *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, No. 81-349 (argued April 19, 1982, restored to calendar on May 3, 1982 for rehearing next term). However, the Illinois Legislature has recently passed a measure which would prohibit "worldwide combination" for 1982 and subsequent years. [11]

The U.S. Treasury Department has received numerous requests from other nations seeking protection from state formula apportionment of "worldwide combined" income in a multicorporate context. [12] The state practice of formula apportion-

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[10] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 94 (September 30, 1981).

Assembly Bill 525, which passed the California Assembly in February, 1980 by a vote of 64-10, precluded the California Franchise Tax Board from requiring use of combined reporting by foreign corporations with United States subsidiaries doing business in California. The California Senate approved an amended version of AB 525. The Senate and House could not agree on the final version of the bill.

[11] House Bill 2588, which eliminates combined reporting on both a domestic and worldwide basis, passed the Illinois House on a vote of 108-46 and the Senate on a vote of 46-12. This bill is currently awaiting the Governor's action.

[12] *See* Report of the Department of State to the President (June 8, 1976): "This method of assessment, which includes the burden of producing worldwide records of all of the affiliated companies, has raised many objections

ment of "worldwide combined" income "has created, and continues to create, an irritant in the international relations of the United States". [13] This irritation has created a potential for retaliation through discriminatory taxes by foreign governments against U.S. citizens or corporations. On April 27, 1982 in a debate in the British House of Commons between the Financial Secretary to the Treasury, Nicholas Ridley, and Chairman of the Conservative Party's Industry Committee, Michael Grylls, a warning was issued that substantial pressure is being exerted in the British Parliament to take retaliatory legislative action to apply a "worldwide combined" reporting system on U.S. corporations which operate in Britain. [14] As the Court stated in *Japan Line:*

> "If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer." 441 U.S. at 450.

In testimony before the U.S. Senate Foreign Relations Committee on July 19, 1977, Assistant Secretary of the Treasury, Laurence N. Woodworth, stated that state formula apportionment in an international context produces complaints from our

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by our treaty partners and we are now seeking to deal specifically with this problem in our treaties." CCH Tax Treaties ¶ 8103 EE.

[13] *State Taxation of Foreign Source Income: Hearings on H.R. 5076 before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 7 (1980) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

[14] Hansard, British Firms Overseas (Taxation) at 823-828 (April 27, 1982).

treaty partners and varies from the internationally-accepted arm's length practice, leading to possible double taxation and, in effect, extraterritorial taxation. [15]

Application of the apportionment formula method on a "worldwide combination" basis is thus a clear violation of the second test of *Japan Line*. It impairs "federal uniformity in an area where federal uniformity is essential". 441 U.S. at 448. The major trading nations of the world and the tax treaties between the United States and other countries apply the separate corporate entity approach pursuant to the internationally-accepted arm's length standard. At the federal level, the United States has spoken uniformly in this crucial area of taxes on international trade and foreign commerce where federal uniformity is so essential. That voice is reflected in our many tax treaties, in the use of the arm's length concept under Internal Revenue Code section 482 rather than formula apportionment for federal income tax purposes, in the enactment by Congress in 1959 of Public Law No. 86-272 (73 Stat. 555) limiting the jurisdictional bases open to states for taxation and in the numerous pronouncements by high executive officials in the government. [16]

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[15] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 33 (1977).

[16] *In U.S. Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. at 488-499 (1977), Mr. Justice White, in his dissent with which Mr. Justice Blackmun concurred, stated that "both Congress and the Executive have clearly demonstrated that there is a federal interest in the rules for apportioning multistate and multinational income. The Executive cannot constitutionally express his federal sovereign interest in the matter any more unambiguously. He has negotiated a treaty with a foreign power and submitted that treaty to the Senate. As for the Congress, its federal sovereign interest in the topic was early established in Public Law No. 86-272".

The California Franchise Tax Board endeavors to contradict the voice of the United States with respect to the arm's length method by seeking the approval of this Court of its inconsistent "worldwide combination" formula. Its "worldwide combination" method directly burdens foreign commerce in contravention of this Court's decision in *Japan Line*.

Appellee will argue that "worldwide combination" does not burden the Commerce Clause because the California Franchise Tax Board is not directly taxing the income of a foreign corporation. What is overlooked, however, is that the state is recasting the income of foreign corporations (including income which has satisfied the I.R.C. section 482 arm's length test) and taxing it as if it were the income of the jurisdictionally-present taxpayer. By this guise, the state is doing indirectly (*i.e.* taxing foreign income in a "worldwide combined" report) what it is prohibited from doing directly (*i.e.* taxing the foreign corporation). This should not be allowed. It would substitute multiple voices (the states) for the one voice of the United States government despite both the practical necessity and constitutional requirement for "speaking with one voice" in the area of foreign commerce.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below and remand the case to the Court of Appeal of California, First Appellate District, for further proceedings in conformity with this Court's opinion.

Respectfully submitted,

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July 26, 1982

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No. 81-523

In the Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from The Court of Appeal of California, First Appellate District

Motion of the Committee on Unitary Tax To File Brief Amicus Curiae

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No. 81-523

In the Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
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v.

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Appellee.

On Appeal from The Court of Appeal of California, First Appellate District

Motion of the Committee on Unitary Tax To File Brief Amicus Curiae

The Committee on Unitary Tax (hereafter "CUT") respectfully moves this Court for leave to file in the case now pending, set for argument this fall, this brief *amicus curiae* that it previously filed in the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.,* Supreme Court No. 81-349, argued this spring. The interest of *amicus curiae* and the reasons for granting the motion are stated below.

Amicus curiae is a California nonprofit corporation, comprised of members concerned with state taxation of international business and in particular with taxation by California of such business. Members principally include corporations organized under the law of other nations and the United States subsidiaries of such non United States corporations, but also include corporations organized under the law of various states of the United States and individuals.

Many of the members of CUT are corporations doing business in California (hereafter "California corporations") which have parent and affiliated corporations doing no business in California. Nevertheless, California has sought to include the worldwide income of such parents and affiliates in combined tax reports with such California corporations in the same fashion which it has included worldwide income from the foreign subsidiaries in the combined reports filed by appellant Container Corporation of America in this case.

This Court's recent decisions in *ASARCO, Incorporated v. Idaho State Tax Commission,* ..... U.S. ..... (1982) and *F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico,* ..... U.S. ..... (1982) set forth standards under the Due Process Clause of the United States Constitution for taxation by a state of income earned by entities not doing business within the state. These decisions may very well dispose of this case since the operations of appellant Container Corporation of America in the United States seem discrete and separate from those of its foreign subsidiaries. Thus, this Court may not reach other important issues which arise under both the Due Process Clause and under the Commerce Clause.

Should, however, the Court choose to reach such other issues which are posed by appellant Container Corporation of America in this case, the Brief to be filed by amicus curiae not only addresses those issues but points up the differences in degree of impact and burden on foreign parents with domestic subsidiaries. These differences have not been addressed by the courts below and they will not be addressed by the parties in this case. Amicus curiae has received consent from appellant to file this Brief, a copy of which is included as Exhibit A, and understands that a

general consent has been given by appellee, Franchise Tax Board.

This Brief was originally filed in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, Supreme Court No. 81-349, pursuant to the consent of the parties in that case. The California combined reporting method under consideration in this case has the same infirmities as the Illinois method under consideration in that case. Thus, although this Brief refers to *Chicago Bridge & Iron Co.* as the appellant and to the Illinois tax system, legal issues and authorities cited in this Brief remain applicable to this case.

Amicus curiae therefore respectfully requests that the Court accept the Brief as previously filed by amicus curiae in the *Chicago Bridge & Iron Co.* case for filing in this case. Amicus submits herewith forty copies of that Brief.

Respectfully submitted,

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Appendix A

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Re: Container Corporation of America v.
Franchise Tax Board, U.S. Supreme Court
No. 81-523

Dear Joanne:

As counsel for Container Corporation of America, I consent to the filing of an *amicus* brief by the Committee on Unitary Tax in the above case.

Sincerely,

/s/ FRANKLIN C. LATCHAM

Franklin C. Latcham

FCL:as

No. 81-349

In the Supreme Court of the United States

OCTOBER TERM, 1981

CHICAGO BRIDGE & IRON COMPANY,
Appellant

vs.

CATERPILLAR TRACTOR CO.,
ILLINOIS DEPARTMENT OF REVENUE, et al.,
Appellees

Appeal from the Supreme Court of Illinois

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INDEX

Page

Table of Authorities iii

Interest of Amicus 1

Summary of Argument 2

Argument 3

I. The Same Tests of Validity of a State Taxing Statute Under the Commerce Clause Should Be Used for Income Taxation of a Unitary Business Engaged in Foreign Commerce as for Property Taxation of an Instrumentality of Foreign Commerce 5

II. The Use of Worldwide Combined Reporting Increases the Risk of Multiple Taxation Beyond the Acceptable Commerce Clause Limits 6

A. The International Standard of Income Taxation Adopts a Water's Edge Approach 8

B. The Conceptual Differences Between Combined Reporting and the Water's Edge International Standard Raise a Substantial Risk of Multiple Taxation 10

C. This Court Has No Power to Prefer the Apportionment Method of Combined Reporting Over an Internationally Accepted Concept in the Context of Foreign Commerce 13

D. In Foreign Commerce the Risk of, Rather Than Actual, Multiple Taxation Should Be Sufficient to Invalidate Combined Reporting Because the Risk is Identifiable 14

Page

E. This Court Can Eliminate Even the Risk of Multiple Taxation by Limiting Combined Reporting to the United States 15

III. Worldwide Combined Reporting Impairs Federal Uniformity in an Area Where Federal Uniformity Is Essential 16

A. Worldwide Combined Reporting Frustrates the Achievement of Federal Uniformity 18

B. Worldwide Combined Reporting Impinges Upon the National Policy of Removing Impediments to the Free Flow of Trade and Commerce 20

IV. Worldwide Combined Reporting When Applied to Foreign Based Taxpayers Unfairly Apportions Income and Discriminates Against Foreign Commerce 22

Conclusion 29

Appendix A ..... Appendix 1

Appendix B ..... Appendix 2

Appendix C ..... Appendix 4

Appendix D ..... Appendix 6

Appendix E ..... Appendix 9

Appendix F ..... Appendix 12

Appendix G ..... Appendix 17

TABLE OF AUTHORITIES

Cases	Pages
Appeal of Beecham, Inc., California State Board of Equalization, March 2, 1977	18
Board of Trustees v. United States, 289 U.S. 48 (1933)	16
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, rehearing denied, 430 U.S. 976 (1977)	3, 4, 5, 22, 23
Exxon Corporation v. Wisconsin Department of Revenue 447 U.S. 207 (1980)	12
Gibbons v. Ogden, 9 Wheat. 1 (1824)	16
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	2, 3, 4, 5, 6, 7, 8, 12, 13, 14, 16, 17, 20, 22, 26
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980)	7, 14
Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978)	5, 7, 12, 14, 15, 18
Northwest Airlines, Inc. v. Minnesota, 322 U.S. 292 (1944)	28
Appeal of Shachihata, Inc., California State Board of Equalization, January 9, 1979	18
Standard Oil v. Peck, 342 U.S. 382 (1952)	14
Zschernig v. Miller, 389 U.S. 429 (1960)	16
Constitution	
Commerce Clause, Article I, § 8, Cl. 3	4
Statutes	
Internal Revenue Code of 1954 (26 U.S.C.) Section 482	7

Pages

Illinois Income Tax Act (Ill. Rev. Stat., 1979, Ch. 120, par. 1-102 et seq.) 4
Section 203 16
Section 304(a)(1) 23
Section 404 7

OTHER AUTHORITIES

Treasury Department Tax Option Reform Paper No. VIII 10
Illinois Department of Revenue Proposed Regulations (Illinois Register, Vol. 5, Issue 29, July 17, 1981) 4
Section 304-1(b)(2) 11, 25
Memorandum Report, dated September 4, 1981, of the Staff of the Advisory Commission on Intergovernmental Relations to Members of the Commission .. 8, 9
Statement of John S. Nolan on behalf of the Confederation of British Industry and the British National Committee of the International Chamber of Commerce before House Ways and Means Committee on H.R. 5076 21
Hearings before California Franchise Tax Board on July 12 and August 22, 1977, on California Unitary Tax 24
Background Information on California Bank and Corporation Tax, Unitary Method of Apportionment, Volume II, prepared by the Staff of the California Assembly Revenue and Taxation Committee for Interim Hearing, November, 1979 (Publication No. 750) 24
Transcript of Interim Hearing, California Bank and Corporation Tax, Unitary Apportionment and Worldwide Combination, Volume III, California Assembly Revenue and Taxation Committee, November 13, 1979 24

Page

Comments by Peter Rees, Minister of State, Treasury; Debates in House of Commons, February 18, 1980, Hansard, Parliamentary Debates, p. 179 22

Objections by Governments of Canada, France, United Kingdom and the European Economic Committee as contained in Letter to Hon. Allan J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada, from G. William Miller, U.S. Secretary of Treasury, dated September 26, 1980; Letter to His Excellency, Francois de Laboulaye, Ambassador of France, from George S. Vest, U.S. Assistant Secretary, European Affairs, November 24, 1978; Letter to Hon. Harry F. Byrd, Jr., Chair, Taxation Subcommittee, U. S. Senate, from J. Anson, Minister, Economics, United Kingdom, dated June 23, 1980; and letter to Department of State from Paolo Pansa Cedronio, Ambassador of Italy, dated March 19, 1980, on behalf of the Nine EEC Governments.... 19

Donald R. Ravenscroft, *Taxation and Foreign Currency*, Harvard Law School (1973) 26

"Developments in the Law—Federal Limitations on State Taxation of Interstate Business," 75 *Harv. L. Rev.* 953 (1962) 26

Financial Accounting Standards Board Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, American Institute of Certified Public Accountants (1975) 26

1978 Annual Report of Unilever Limited and Unilever N.V. 27

Page

Brief Amicus Curiae of the Multistate Tax Commission in Response to Appellant's Jurisdictional Statement 10

Motion of Appellee, California Franchise Tax Board, to Dismiss or Affirm in *Container Corporation of America v. Franchise Tax Board*, No. 81-523, October Term, 1981 19

In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-349

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vs.

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ILLINOIS DEPARTMENT OF REVENUE, et al.,

Appellees

Appeal from the Supreme Court of Illinois

Brief for Committee on Unitary Tax as Amicus Curiae

INTEREST OF AMICUS

The Committee on Unitary Tax hereby respectfully files this Amicus Curiae Brief in support of Appellant Chicago Bridge & Iron Company. The consents of the attorneys for Appellant and for Appellees are attached hereto as Appendices "A," "B," and "C."

Amicus Curiae is a California nonprofit corporation comprised of members concerned with state taxation of international business. Members principally include corporations organized under the laws of other nations and United States subsidiaries of such non United States corporations, but also include corporations organized under

the laws of various states of the United States and individuals.[1]

SUMMARY OF ARGUMENT

Since a portion of the income which may be subject to tax by Illinois under worldwide combined reporting of separate entities, including those incorporated and doing business in foreign nations, was earned in foreign commerce, the additional inquiries developed in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979) should apply to test compliance of the Illinois corporate income tax with the Commerce Clause.

Worldwide combined reporting fails the first inquiry under *Japan Line* because it substantially increases the risk of multiple taxation of international businesses. Combined reporting ignores geographic boundaries whereas the international standard of taxation uses a separate accounting approach based on geographic boundaries. Multiple taxation will occur where a foreign sovereign taxes to its water's edge, and the state share of income determined by worldwide combined reporting exceeds U.S. source (i.e., U.S. water's edge) income. This Court has no jurisdiction to force a foreign sovereign to accept apportionment of taxes in preference to that sovereign's method of taxation. Thus, this Court cannot insure that the aggregation of taxes is computed on no more than the total net income of an international business. Because this risk of multiple taxation is identifiable and is inherent in the system, proof of risk, rather than proof of actual multiple taxation should be sufficient.

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1. The countries of incorporation of members, or parent corporations of members, include Japan, the United Kingdom, The Netherlands, Switzerland, Korea, West Germany and Canada.

Worldwide combined reporting also fails the second *Japan Line* test because it impairs federal uniformity and increases the risk of international disputes over reconciliation of apportionment formulae at a time when the federal government has entered into a number of taxation treaties with the dual goals of establishing uniformity of treatment and removing impediments, including double taxation, to the free flow of trade. The multiplicity of non-uniform state taxing systems further exposes foreign commerce to inconsistent treatment, thus preventing the Nation from speaking with one voice. Although this case involves domestic corporations, combined reporting has already resulted in numerous objections from foreign nations with the possible risk of retaliation should it be applied to entities owned and controlled by foreign-based businesses. This Court can avoid such difficulties by confining combined reporting to the United States.

Finally, worldwide combined reporting fails the fair apportionment and lack of discrimination tests for compliance with the Commerce Clause as established by *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), particularly when applied to foreign owned businesses. Arbitrary and distorted results occur from such application because of the differences in economic and political systems, and the cost of compliance by foreign owned unitary businesses increases to such a degree as to be discriminatory.

ARGUMENT

The Illinois Supreme Court has ruled in this case that it is proper to combine the incomes of separately incorporated corporations doing business within and without the United States to determine the share of income which Illinois may tax under its income tax. This case involves a United States domestically incorporated parent (Cater-

pillar Tractor Co.) with numerous subsidiaries, including several incorporated under the laws of foreign countries. The intervenors in the case, which include appellant herein, were similarly situated.[2]

Amicus contends that combined reporting which would include in the tax base the income earned without the United States by entities incorporated under the laws of a foreign nation fails Commerce Clause (Article I, Section 8, Clause 3) standards as set forth in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) (hereafter referred to as *"Japan Line"*), and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, rehearing denied, 430 U.S. 976 (1977).

Amicus further suggests the proper answer which this Court should reach is to permit combined reporting of all entities doing business within the United States only as to their United States source income.[3] This solution, as hereafter discussed, will preserve the international harmony and fairness sought by the framers of the Commerce Clause in the Constitution, eliminate the complex problems of information gathering which mar the alleged simplicity of reporting claimed by the states in their use of appor-

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2. Amicus is primarily concerned with foreign based unitary businesses with United States subsidiaries. The Illinois Income Tax Act and Proposed Regulations, thereto (Appendices E and G to Appellant's Jurisdictional Statement, respectively, all references hereafter to Appellant's Appendices to refer to the Appendices to Jurisdictional Statement) do not contain any apparent exception from worldwide combined reporting for such businesses.

3. The United States factors would be included and factors outside the United States would be excluded from the apportionment formula. This case does not raise the question of the foreign source income of a single corporation doing business within and without the United States, and Amicus specifically requests the Court not to reach this issue. Amicus believes that there may be differences in the proper analysis where a foreign corporation, foreign-owned, is doing business within and without the United States as opposed to a United States corporation, domestically owned.

tionment, and still preserve a state's freedom to construct its own taxing methods within the geographic confines of the entire United States.

I. The Same Tests of Validity of a State Taxing Statute Under the Commerce Clause Should Be Used for Income Taxation of a Unitary Business Engaged in Foreign Commerce as for Property Taxation of an Instrumentality of Foreign Commerce.

The tests developed in *Complete Auto Transit Inc. v. Brady, supra,* (application to an activity with a substantial nexus with the state, fair apportionment, non-discrimination against interstate commerce and fair relationship to services provided by the state) have been applied to all forms of taxation of interstate business, including income tax. See, e.g., *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267 (1978). Amicus discusses in Part IV of this brief whether the combined reporting method is fairly apportioned when applied to foreign owned unitary businesses and whether such method discriminates against foreign-owned businesses. Amicus believes that upon careful scrutiny such application fails even the basic tests of *Complete Auto Transit, Inc. v. Brady, supra.*

However, the additional two tests developed in *Japan Line* (hereafter referred to as "*Japan Line* Tests Five and Six"), should have particular applicability in measuring compliance with the Commerce Clause when dealing with questions of foreign commerce. The *Japan Line* tests should not be restricted to instrumentalities of foreign commerce but should apply to all foreign commerce: the intrusion of the states into areas of foreign commerce is no less burdensome because the states select one method or one object of taxation as opposed to another.

The Supreme Court of Illinois distinguished *Japan Line, supra,* on the basis that combined reporting did not involve multiple taxation of items of foreign commerce or affect

the federal authority in governing foreign commerce. Since the purpose of the apportionment formula was to confine taxation of business income to the portion attributable to activities within Illinois, the court reasoned that the concern was only with the taxation of business income fairly attributable to activities within Illinois.

The purpose of *any* apportionment formula—including the formula used by California in *Japan Line, supra,* is to confine the taxes levied on the object of taxation—whether it be income or instrumentalities of commerce—to the taxing authority's "fair share." And, as this Court pointed out in *Japan Line,* even a fairly apportioned state tax may fail the Commerce Clause standard where foreign commerce is involved. 441 U.S. at 448.

Applying an apportionment formula to worldwide net income to determine the share of that income to tax is no different than using a port-day formula to determine the share of the value of containers to tax. If the containers are used in foreign commerce, the question is one of foreign commerce. If the activities of the unitary business involve foreign commerce, the question should also be one of foreign commerce. Both the Appellant and Caterpillar Tractor Co. have multinational subsidiaries whose income would be combined as part of the tax base. That income was earned in activities in foreign commerce.

II. The Use of Worldwide Combined Reporting Increases the Risk of Multiple Taxation Beyond the Acceptable Commerce Clause Limits.

The first of the additional inquiries added by this Court in *Japan Line* to test the validity of a state taxing statute under the Commerce Clause is:

> "Whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation...." 441 U.S. at 451

This Court went on to point out in footnote 17:

> "Because California's tax in this case creates multiple taxation in fact, we have no occasion here to decide under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate, commerce." 441 U.S. at 452 (citations omitted)

In its more recent decisions involving interstate commerce, this Court has not found actual multiple taxation and has perhaps suggested that in the domestic context something more than the speculative possibility of such multiple taxation must be present. See, e.g., *Moorman Manufacturing Co. v. Bair, supra; Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425 (1980). Moreover, this Court has been loath to decide, in domestic situations, which taxing state may be "causing" the possible multiple taxation. *Id.*

This case, however, involves foreign, as well as interstate, commerce, and more than the theoretical risk of taxation rejected by this Court in *Mobil Oil Corp. v. Commissioner of Taxes, supra.* Unlike New York which had not imposed any tax on dividends received by its commercial domiciliaries, most foreign nations do tax income earned within their borders under the "arm's length" method.[4]

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4. The arm's length method of accounting is a corollary of "separate accounting" which allocates the business income of a single entity to a geographic location. To deal with transactions between related entities, an arm's length standard is used. If such transactions do not meet the "arm's length" standard, they can be reallocated by taxing authorities. See e.g., Section 482 of the Internal Revenue Code. Many states have statutes similar to Section 482, including Illinois. See Illinois Income Tax Act Section 404 (Appellant's Appendix E at E-26).

There is no showing of actual multiple taxation in the record, but Amicus urges the Court to require only the risk of multiple taxation and not its actual presence. The differences between taxation of foreign and domestic commerce require a different result: the presence of an international standard of taxation which differs in concept and practice from the unitary method will result in multiple taxation in certain circumstances, and, because the standard has been adopted by foreign sovereigns, this Court has no authority to require apportionment as a cure for multiple taxation.

A. THE INTERNATIONAL STANDARD OF INCOME TAXATION ADOPTS A WATER'S EDGE APPROACH.

This Court pointed out in *Japan Line* that the custom of nations, as well as various treaties to which the United States was a party, permitted the domiciliary nation to tax instrumentalities of commerce in full at their domicile. There is a similar international income tax standard memorialized in numerous treaties of double taxation to which the United States is a party.[5]

This international standard is described in the Memorandum Report, dated September 4, 1981 ("Report"), of the staff of the Advisory Commission on Intergovernmental Relations:

> "The gain to the nation from reducing tax-based barriers to the free movement of resources across national borders is clear. What must also be made clear is that there are requirements to be met before these gains can be realized. Specifically, tax harmonization cannot occur without an *internationally accepted set of standards* which serve as the foundation for all tax treaty negotiations.

5. The United States is a party to treaties of double taxation of income with over 50 nations.

"Internationally Accepted Standards

"These internationally accepted standards set forth principles for taxing foreign owned enterprise operating in the United States and U.S. owned enterprise operating abroad. Two important sets of rules for this purpose are: (1) those defining a *permanent establishment* in the host country, since the host country can only tax business profits attributable to such a permanent establishment, and (2) those specifying procedures for accounting for transactions between related parties in measuring the income of the permanent establishment. Under these latter rules, the permanent establishment, such as a branch or subsidiary corporation, is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis;* that is, as if the related parties were dealing with each other as independent enterprises at arm's length.

"These standards have evolved from about 50 years of effort on the part of both technical experts and negotiators of tax treaties. In 1932, the first tax convention to which the U.S. was a party, that is a tax convention with France, adopted the arm's length concept. In 1934, through work supported by the League of Nations, the first model tax treaty was developed incorporating the arm's length standard. The model income tax treaty of the Organization for Economic Cooperation and Development (OECD), most recently revised in 1977, similarly embraces this arm's length concept as does the United States' model tax treaty also most recently issued by the Treasury Department in 1977.

"Thus, the standard reflected in both OECD and United States model income tax treaties is a 'water's edge' rule." (Footnotes omitted; emphasis in original) Report, pp. 8-9.

See also, Treasury Department Tax Reform Option Paper No. VIII, Appellant's Appendix F.

This concept is in contrast to the unitary method and most particularly to its extension, combined reporting, which ignores geographic boundaries.[6]

B. THE CONCEPTUAL DIFFERENCES BETWEEN COMBINED REPORTING AND THE WATER'S EDGE INTERNATIONAL STANDARD RAISE A SUBSTANTIAL RISK OF MULTIPLE TAXATION.

Because the principles underlying the two methods of taxation—water's edge[7] and worldwide combination and apportionment—are different, a corporation or group of corporations, engaged in business both within and without the United States, always runs a risk of multiple taxation. Whether actual multiple taxation may occur depends upon circumstances from year to year, often on the location of profits of a business within and without the United States.[8]

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6. Mr. Dexter in his brief on behalf of the Multistate Tax Commission in response to the jurisdictional statement contends that there is nothing in the record to substantiate appellant's argument "that the unitary method here involved conflicts with such [international] standards, agreements and norms." Footnote 9 at p. 5. Amicus suggests that this Court can take judicial notice of treaties, treatises and legislative testimony on this subject to find more than sufficient evidence. However, since Amicus primarily represents foreign parents with both domestic and foreign subsidiaries, Amicus would like to point out Mr. Dexter's apparent concession that evidence of such accords does exist in the case of foreign parents:

> *"While there may be international agreements between the United States and certain other nations pertaining to taxation of the domestic operations of foreign parent corporations,* no such agreements exist as to how nations will tax their own domestic corporations...." *Id.*

7. The term "water's edge method" for purposes of this brief will mean separate accounting within the territorial limits of the taxing jurisdiction with an arm's length standard applied to transactions between related entities.

8. When a unitary business reports a greater percentage of its net income outside the United States than within with respect to the average of the formulary apportionment factors, the form-

The following simplified example illustrates the clash between the two concepts of taxation when applied to a unitary business conducted by a foreign parent and a U.S. subsidiary. The foreign parent does all of its business in a foreign country. The subsidiary does all of its business in Illinois. The net income earned by the foreign country corporation is One Million Dollars as measured by the laws of that country (and translated into U.S. dollars). The net income earned by the subsidiary is Five Hundred Thousand Dollars as measured by United States federal income tax law. Under both the arm's length method and the unitary method the total net income of the two corporations is One Million Five Hundred Thousand Dollars.[9] Under the foreign country's taxing system which is the standard water's edge concept One Million Dollars will be subject to tax. The foreign country has no claim to, or interest in, the balance of the income until it is repatriated. Under the unitary system, some share of One Million Five Hundred Thousand Dollars, or the aggregate of the taxable incomes of the two corporations, will be subject to tax by Illinois. What that share will be will depend upon a formula based on the relation of factors within Illinois to factors worldwide (generally property, payroll and sales). If the formula results in a relationship of factors which in turn

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ulary apportionment will "reach" some of that income. For example, if corporation A, doing business without the U.S., reports net income of $100,000 and corporation B, doing business within the U.S., reports net income of $50,000, for a worldwide income of $150,000, and if the factors of these corporations are equal, under the combined reporting method, B's net income for tax purposes will be regarded as increased from $50,000 to $75,000.

9. The practice in those states applying combination is usually to combine the net income of each separate entity to arrive at worldwide net income with some adjustments to conform the base to United States' standards of accounting and the state's tax. See e.g., Proposed Illinois Income Tax Regulations, Section 304-1(b)(2), Appellant's Appendix at p. G-17.

produces a percentage greater than thirty-three and one-third percent, Illinois will claim the right to tax more than Five Hundred Thousand Dollars. If the percentage is less, the share claimed will be less. If, in our example, the percentage derived from the relationship of the factors is fifty percent, Illinois' share of the income to be taxed will be Seven Hundred Fifty Thousand Dollars. Since the unitary business is already subject to tax on One Million Dollars under the first concept, "the aggregation of taxes" (*Japan Line,* 441 U.S. at 447) is actually being computed on more than the agreed full value of the tax base of One Million Five Hundred Thousand Dollars, namely, One Million Seven Hundred Fifty Thousand Dollars.

Taxpayers have not been successful in proving double taxation in the income tax context before this Court. Offers of proof have generally been based on the taxpayer's financial accounting offered as a contrast to the state result. See, e.g., *Moorman Manufacturing Co. v. Bair; Exxon Corporation v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980). Where, however, separate accounting is the preferred approach of a foreign sovereign which has the jurisdiction to tax, evidence of that jurisdiction's *tax base* cannot and should not be rejected. If that tax base, when added to the base of the state determined under the unitary method, exceeds the total tax base, that business is subject to multiple taxation. Because of this every unitary business subject to tax in a state which uses worldwide combination and also subject to tax in a foreign jurisdiction which adopts the international standard bears a burden quite different than a domestic unitary business not doing business in such foreign jurisdiction. Although combined reporting may be facially neutral, in practice it subjects such businesses to the risk of burdens not borne by others. *Japan Line, supra.*

C. THIS COURT HAS NO POWER TO PREFER THE APPORTIONMENT METHOD OF COMBINED REPORTING OVER AN INTERNATIONALLY ACCEPTED CONCEPT IN THE CONTEXT OF FOREIGN COMMERCE.

Prior to *Japan Line* this Court had been able to set itself up as arbiter, in Commerce Clause inquiries, between competing tax systems, and had the luxury of choosing or declining to choose which of the competing methods of taxation to which a business was subjected—or might be subjected—was the cause of possible unfairness.

In *Japan Line,* however, this Court faced a situation where it was clear that there were two competing approaches to taxation, and, even though this Court preferred one system—namely apportionment—it was powerless to reconcile differences. It could not command a sovereign state to change its system, particularly where this system was part of an international approach accepted by the United States through its treaties.[10]

Likewise, in this case this Court is powerless to compel a foreign country to abandon its own water's edge standard to accept some form of unitary apportionment. As this Court has pointed out in *Japan Line, supra,* the "basis for this Court's approval of apportioned property taxation ... has been its ability to enforce full apportionment by all potential taxing bodies." 441 U.S. at 447. But where multiple taxation is a substantial risk as here,[11]

> "[d]ue to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax,

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10. Like treaties of double taxation, the Customs Convention on Containers did not specifically deal with state as opposed to federal taxation.

11. Since the water's edge system taxes on a geographic basis (income earned within borders) and worldwide combined reporting ignores geographic boundaries, it is highly likely, as in the example at pages 11-12 of this brief, that each system will claim an overlapping portion of the total tax base, *i.e.*, worldwide net income.

even though 'fairly apportioned' to reflect an instrumentality's presence within the state may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed and which the Commerce Clause forbids.'" *Japan Line, supra,* at 447-448 quoting *Evco v. Jones,* 409 U.S. 91 at 94 (1972), and *J. D. Adams Mfg. Co. v. Storen,* 304 U.S. 307 at 311 (1938)

D. IN FOREIGN COMMERCE THE RISK OF, RATHER THAN ACTUAL, MULTIPLE TAXATION SHOULD BE SUFFICIENT TO INVALIDATE COMBINED REPORTING BECAUSE THE RISK IS IDENTIFIABLE.

Amicus suggests to this Court that the risk of multiple taxation inherent in the application of worldwide combined reporting to income of entities not doing business within the United States should be sufficient to invalidate its use when applied beyond the United States. The risk is systemic and identifiable: so long as a sovereign nation adopts a method of taxation in accord with the water's edge concept, as do most nations, and states such as Illinois adopt worldwide combined reporting which does not limit itself to geographical boundaries, multiple taxation will occur if the apportionment method includes in its tax base more than *U.S. source income as identified by the international standards.*

This is not the speculative risk of *Mobil Oil Corp. v. Commissioner of Taxes, supra,* where there was multiple taxation only if New York chose to tax dividend income by allocation and where such multiple taxation can be corrected by this Court—presumably by requiring apportionment.

This Court has recognized that differing systems of taxation and differing formulas will produce multiple tax. See *e.g., Mobil Oil Corp. v. Commissioner of Taxes, supra; Standard Oil v. Peck,* 342 U.S. 382 (1952); *Moorman Manufacturing Co. v. Bair, supra,* at 277, fn. 2. The only

uncertainty is whether in any given year the two incompatible systems will produce multiple taxation.

Because this risk inheres in the *system* and is identifiable, proof of actual multiple taxation should not be necessary.[12]

E. THIS COURT CAN ELIMINATE EVEN THE RISK OF MULTIPLE TAXATION BY LIMITING COMBINED REPORTING TO THE UNITED STATES.

This Court can eliminate all risk of, and any actual, multiple taxation by limiting the application of combined reporting to the water's edge of the United States. Thus, combined reporting cannot include in its share of the tax base that potential overlap between the state's claimed share and the share determined under the international standard: there is no overlap.

The limitation to water's edge preserves the freedom of the states to experiment within the entire United States with their own approaches to tax.[13] There is no necessity to invalidate the entire state's taxing statute: there seems to be no constitutional reason under the Commerce Clause why combined reporting could not be limited to the United States where this Court can correct inequities when they arise.[14] The amount of United States income of a unitary

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12. Amicus does not describe this as a *flaw* in the system; it is simply different than the other system accepted internationally, and, as this Court recognized in *Moorman Manufacturing Co. v. Bair*, differences in systems produce duplicative tax. 437 U.S. at 278.

13. It should be noted that not all states adopt the unitary concept, and that most do not use either worldwide combined reporting or combined reporting. There are also numerous variations on formulas as this Court was well aware in *Moorman Manufacturing Co. v. Bair*. To transfer these questions into the international sphere will add needless complexities to an already complex area.

14. Amicus' comments are confined to the application of the Commerce Clause in the context of a unitary business doing business within and without the United States and it does not comment on any other Constitutional impediments that may arise from the application of combined reporting within the context of interstate commerce.

business is readily available and many of the states use the federal tax base as the starting figure.[15]

This approach will also save this Court (and other courts) from the avalanche of highly technical cases seeking to prove mulitple taxation in the year in which it occurs. The risk of multiple taxation is identifiable but is not quantifiable except on a year by year basis. To expect a taxpayer to continually litigate in those years when the extent of such multiple taxation is known leads to poor tax policy and administration since it leaves unsettled an area which this Court can settle.

In these very murky international waters, the time of this Court would be better served by finding that the export of this system beyond the water's edge is not proper.

III. Worldwide Combined Reporting Impairs Federal Uniformity in an Area Where Federal Uniformity Is Essential.

The second of the additional Commerce Clause inquiries made by this Court in *Japan Line, supra,* is:

> "Whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" 441 U.S. at 451.

Foreign commerce is preeminently a matter of national concern. This Court has stressed in *Japan Line, supra,* and numerous other cases the need for a national approach in "foreign intercourse and trade" and uniformity in treating with other nations.[16] Examples of how a state tax on instrumentalities of foreign commerce might frustrate the achievement of federal uniformity are described by this Court in *Japan Line*:

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15. See e.g., Illinois Income Tax Act, Section 203 (Appellant's Appendix E at p. E-3 et seq.).

16. See e.g., *Gibbons v. Ogden,* 9 Wheat. 1 (1824); *Board of Trustees v. United States,* 289 U.S. 48 (1933); *Zschernig v. Miller,* 389 U.S. 429 (1960).

> "If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States follow the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce." 441 U.S. at 450-451 (footnotes omitted).

This Court pointed out that the tax in question in *Japan Line, supra,* also conflicted with a national policy, evidenced by the Customs Convention on Containers, to remove impediments to the use of containers as instruments of international traffic. The asymmetry created by the California tax, which operated to Japan's disadvantage, would undoubtedly prompt retaliation. One other state (Oregon) was already following this approach, thereby subjecting foreign-owned containers to various degrees of multiple taxation, dependent upon which American ports they would enter.

The effects of combined reporting are strikingly similar when applied to a worldwide unitary business which is foreign-owned and controlled.[17] Because Illinois has no

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17. The Appellant and Appellee, Caterpillar Tractor Company, are domestic businesses. Many of the arguments which Amicus makes in this section may or may not apply to domestic businesses. However, the difficulties which worldwide combined reporting are causing in international relations are sufficiently serious to be brought to this Court's attention.

exemption in its statute for such entities, and, because California which has a similar statute is already applying worldwide combined reporting to foreign-owned entities,[18] Amicus urges this Court to consider the effects of this statute on all potential taxpayers to avoid needless litigation. As Mr. Justice Powell suggested in his dissent in *Moorman Manufacturing Co. v. Bair, supra,* the Commerce Clause inquiry into whether a statute has a particularly burdensome or discriminatory effect is not tied to the effect on a particular corporation's income but focuses on the impact on commerce in general. Footnote 3, 437 U.S. at 287.

A. WORLDWIDE COMBINED REPORTING FRUSTRATES THE ACHIEVEMENT OF FEDERAL UNIFORMITY.

The Court's first illustration of the effect of the property tax on instrumentalities of commerce was the possibility of international disputes over the reconciliation of apportionment formulae. Worldwide combined reporting, because it is different than the water's edge international standard used by most other nations, will bring this Court into exactly those types of international disputes. Amicus has shown in Part II of this brief that the two approaches automatically produce conflict. It is difficult enough to attempt to reconcile apportionment formulae in interstate commerce.

To add the dimension of foreign commerce where the Court admits it has no authority to effect such a reconciliation, and where there is really no international tribunal available to do so, could very well lead to the second frustration which the Court predicts, namely retaliation by foreign nations against American businesses abroad. The concern

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18. See *e.g., Appeal of Beecham, Inc.,* California State Board of Equalization, March 2, 1977; *Appeal of Shachihata, Inc.,* California State Board of Equalization, January 9, 1979.

of such nations has already been expressed by, among others, Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of European Economic Community ("EEC").[19]

Finally, if other states follow the example of the State of Illinois (and those very few states which presently apply combined reporting), foreign-owned businesses and domestic businesses could be subjected to the varying degrees of multiple taxation which would clearly prevent this nation from speaking with one voice in regulating foreign commerce. The impact of this is perhaps best stated in the Motion of the Appellee, California Franchise Tax Board, to dismiss or affirm the petition of Container Corporation of America (No. 81-523) October Term, 1981, filed in this Court:

> "There is *no* absolute uniformity among income tax laws.[4]

"4. Income tax statutes of different states and countries indicate that even where based on separate accounting principles the method of measuring the net taxable income would have some differences in each jurisdiction. There seem to be numerous differences in what are considered *business* income and expenses, and deductions allowed for depreciation and depletion. Statutory difference would seem to be multiplied when individual administration and determinations as to 'reasonable' amounts (particularly allowable as business deductions) enter into the calculations of taxable net income.

"Even the Uniform Division of Income for Tax Purposes Act (UDITPA) used by California (which has been adopted by a number of states and appears to be one of the most uniform methods of apportionment) has some variations among the jurisdictions. It is believed that there is no reasonable possibility of insuring that 100% and only 100% of the income of a unitary business operating in several taxing jurisdictions is included in tax measures." At page 31 of brief (Emphasis in original).

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19. Attached as Amicus' Appendices D through G are the texts of the objections of Canada, France, the United Kingdom and the EEC.

This Court has made it clear in *Japan Line,* that "even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S. at 456.

It might be argued that since this case involves only a domestic appellant, most of these difficulties will not arise. Nevertheless, the difficult problem of reconciling the myriad and non-uniform state systems with the different systems used abroad still will have an adverse impact upon domestic corporations although the threat of retaliation may not be present. Thus, this case still involves sensitive international relations and the potential threat of retaliation. Moreover, foreign governments will be interested in this case because it does involve subsidiaries organized under foreign law and may be indicative of treatment of foreign-owned parents as well.

B. WORLDWIDE COMBINED REPORTING IMPINGES UPON THE NATIONAL POLICY OF REMOVING IMPEDIMENTS TO THE FREE FLOW OF TRADE AND COMMERCE.

This Court in *Japan Line, supra,* pointed out that the desirability of uniform treatment of containers used exclusively in foreign commerce was evidenced by the Customs Convention on Containers which the United States and Japan had signed. The Court stated that the Convention reflected a national policy to remove impediments to the use of such containers in international trade.

The United States has embarked on a similar national policy as reflected in its many treaties of double taxation and its general treaties of friendship, commerce and navigation.

The purpose of the treaties of double taxation is to insure uniformity of treatment of the nationals of contracting

states abroad and reflects a recognition that systems of taxation may in and of themselves be impediments to the free flow of trade. Accordingly, the objective is to reduce the possibility of double taxation by the utilization of accepted standards.

The accepted standard in this network of treaties is the water's edge standard as described in Part II of this brief. Combined worldwide reporting is an asymmetric system.

If this case had as its appellant a foreign-based business, the subversion of this national policy would be obvious. Nationals of the other contracting parties when they come to the United States find themselves not only subject to taxation by the states, which is entirely proper, but, with worldwide combined reporting, taxation by a system which has extraterritorial implications with effect beyond the borders of the United States. This is not simply the problem of multiple taxation; it also includes extensive compilation of information on activities of businesses beyond the borders of the United States, demands not only burdensome but perceived by foreign business as an attempt to export this system.[20]

Because this case involves domestic businesses, the impact upon such national policy is not as readily apparent. However, the fact that this form of taxation has already generated governmental protests to the *federal government* (see Amicus' Appendices D through G) and has been the subject of extensive debate in the British House of Com-

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20. See Statement of John S. Nolan on behalf of Confederation of British Industry and the British National Committee of the International Chamber of Commerce before House Ways and Means Committee on HR 5076, Appellant's Appendix I. See also Part IV of this brief.

mons[21] shows that the matter is one of national—and international—concern.

As the Court pointed out in *Japan Line, supra,* Illinois has created a problem, the solution to which is only in national or international hands. This is a clear undermining of national objectives and prevents our nation from speaking with one voice.

IV. Worldwide Combined Reporting When Applied to Foreign Based Taxpayers Unfairly Apportions Income and Discriminates Against Foreign Commerce.

This Court in *Complete Auto Transit Co. v. Brady, supra,* set forth four basic tests to measure compliance of state taxing statutes against the strictures of the Commerce Clause. Amicus believes that worldwide combined reporting when applied to a unitary business controlled by a foreign

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21. For example in debates in the House of Commons on the United States-United Kingdom Tax Treaty on February 18, 1980, the unitary system was described as "international robbery," and Peter Rees, Minister of State, Treasury, made the following statement:

> "To those who remain concerned about the unitary question, I say that there is no disposition on the part of the Government to let the issue die. If the House approves the convention and if it is ratified thereafter, we shall be prepared to place on record, for all to see, our reservations on the unitary system. The Administration in the United States were left in no doubt by what I told them.
>
> "Between two sophisticated and old friends such as the United States and the United Kingdom fiscal matters are subject to continuing review, and I assure the House that there will be an annual review of the working of this double tax convention. It is absurd for it to be raised automatically every year, but when the moment is propitious we shall be prepared to raise it again.
>
> "The British ambassador in Washington at this moment is mustering the EEC ambassadors to see what kind of common *demarche* can be made on the subject." Hansard, Parliamentary Debates, p. 179.

corporation fails at least two of the four *Complete Auto* tests, namely fair apportionment and nondiscrimination.[22]

The tax is not fairly apportioned because the formula used does not limit the tax to the activities of the business within the state. This is chiefly because the instate apportionment factors (which appear in the numerator) are not of the same quality and relationship as the "offshore factors" which appear in the denominator. The various factors, although using identical labels, are not measuring the same thing.

The most common factors, such as those used in the Illinois Income Tax Act, are property, payroll and sales. The definition of what is included in each of these factors is based upon United States tax and accounting principles. These principles often differ substantially from the accounting and tax principles used in foreign countries. It is the latter which control the recordkeeping of such foreign companies. For example, the books and records of foreign taxpayers with respect to property are often based on replacement cost or in some cases, inflation accounting. United States accounting (and state tax accounting) is based on historical cost (see e.g., Illinois Income Tax Act, Section 304(a)(1)(B), Appellant's Appendix E at p. E-16). Some European countries not only quickly depreciate but actually eliminate from the books certain items of personal property. As a result information is often not available to make the property factors correspond.

The relationships of the factors to the income produced is also different. The economic basis of the unitary formula

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22. The questions of noncompliance with Due Process and Equal Protection standards are already raised by appellant herein. Because of this Amicus makes no comment with respect to the Due Process questions which are somewhat similar to the second and third tests of *Complete Auto Transit Co. v. Brady, supra,* or with respect to the application of these Commerce Clause tests to domestic taxpayers.

is that a dollar of income, a dollar of property, and a dollar of sales in the taxing jurisdiction all contribute more or less proportionately to profits as do a dollar of income, a dollar of property, and a dollar of sales outside the taxing jurisdiction. Within a single economic system distortions in segments of a business tend to more or less even out. However, in different types of economies, particularly those where the costs inherent in the factors and the expectations for profit differ markedly from the United States and where the nature of the economy is often quite different, the mixing of the differences produces a greater distortion than would appear in a uniform economy. Appellant in its jurisdictional statement has mentioned the high cost of compliance with environmental standards (at pp. 28-29) which in turn increases the property factor in the United States. Taxpayers which invest in countries where the risk of expropriation is high are likely to require greater profit margins to justify the additional risk.

None of these problems by themselves might seem unfair, but their aggregation creates a pattern of unfairness in the apportionment formula. Foreign-based taxpayers have perceived this and have complained that the unitary theory of apportionment singles them out for arbitrary and unfair taxation, the evils proscribed by the two *Complete Auto Transit* tests. See, e.g., Hearings before the California Franchise Tax Board in July and August, 1977 on the California Unitary Tax; Hearing before California Assembly Revenue and Taxation Committee, November 13, 1979 (*Transcript, Unitary Apportionment and Worldwide Combination,* Volume III); and particularly the statement of Lever Brothers Company, reproduced at pp. 445-462 in Publication No. 750, *Background Information on California Bank and Corporation Tax, Unitary Method of Apportion-*

ment, Volume II, prepared by the Staff of the California Assembly Revenue and Taxation Committee for Interim Hearing, November, 1979.

The tax also discriminates in practice against foreign commerce as conducted by foreign owned unitary businesses.

The costs of compliance with state substantive tax laws are different and greater for foreign taxpayers than domestic taxpayers under worldwide combined reporting. For example, the Proposed Regulations to the Illinois Income Tax Act require each entity in a group to compute U.S. federal income or its equivalent even though such entities may not be doing any business in the U.S. and do not keep their books and records in accordance with U.S. accounting principles, let alone U.S. federal tax law.[23] This may be burdensome for a domestic taxpayer but at least it starts with U.S. accounting principles. At the hearings in California referred to above one foreign based taxpayer with less than 10% of its business activity in the United States and with less than 1% in California submitted a statement that its general books of account were maintained under the financial reporting laws of the country in which the parent corporation was organized using replacement costs instead of historic costs. To convert the books of its 500 subsidiaries located in over 70 countries to the peculiar requirements of California would be an enormously difficult task, involving reconstruction of the cost records of assets acquired over a period of many years, and taking into account changes in the exchange rates from the various host currencies into dollars from time to time.

This Court has also recognized the practical difficulties that arise in trying to reconcile different formulae. For example, the Court specifically referred in footnote 15 in

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23. See Proposed Illinois Income Tax Regulations, Section 304-1(b)(2), particularly at p. G-19, Appellant's Appendix G.

Japan Line, 441 U.S. at 450 to the difficulty, pointed out by a note in the *Harvard Law Review,* of allocating international bridge time for aircraft engaged in international commerce, with a consequent risk of multiple taxation from overlapping apportionment formulae.[24] Among the practical difficulties arising from worldwide combination, which are exacerbated in the case of foreign parents, is the problem of currency translation. Since the books and records of foreign entities are kept in the currency of their domicile, standards of translating currency (not simply in terms of dollars to foreign currency relationships, but also in terms of timing) have proved difficult to establish and administer. For example, several methods are available to translate foreign income into U.S. income.[25] Financial Accounting Standards Board Statement No. 8[26] requires the use of a variation of the net worth method in accounting for profits for financial purposes. The states have only begun to address the intricacies of income translation. If the states are left to promulgate their own versions, a wide range of translation standards could be applied to a foreign based taxpayer engaged in business in more than one state.

Changes in foreign exchange rates often result in haphazard calculation of apportionable worldwide income. To illustrate, consider the reported income from the annual reports of Unilever Limited and Unilever, N.V. filed with the Securities and Exchange Commission. Unilever Limited is a British corporation linked by a common Board of Direc-

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24. "Developments In the Law—Federal Limitations on State Taxation of Interstate Business," 75 *Harv.L.Rev.* 953, 986 (1962).

25. See generally, Donald R. Ravenscroft, *Taxation and Foreign Currency,* Harvard Law School 1973, for a description of the net worth, profit and loss, combination and other methods used for federal tax purposes.

26. *Accounting for Translation of Foreign Currency Transactions and Foreign Currency Financial Statements,* American Institute of Certified Public Accountants (1975).

tors and a profit equalization agreement with Unilever, N.V., a Dutch corporation. The same combined income is reported in pounds for the British corporation and in guilders for the Dutch corporation. The annual reports yearly contain exchange rate data with regard to income calculation in terms of pounds and guilders. The 1978 annual report notes at page 5:

> *"Exchange Rates*
>
> "There continued to be sizeable movements in exchange rates between the major currencies. The most important feature was the weakening of the U.S. dollar in the second half of the year against almost all other major currencies. Sterling weakened against the guilder and the deutschmark, but strengthened against the dollar. At the end of 1978 the sterling/guilder rate was £1 = Fl. 3.99, compared with £ = Fl. 4.36 at the end of 1977.
>
> "For the purpose of calculating the 1978 combined results we have used the sterling exchange rate current at the year-end of 1978. Combined earnings per share rose by 6 per cent in sterling and fell by 3 per cent in guilders. If the combined results had been calculated at the same rate of exchange as those for 1977, earnings per share would have risen by 9 per cent in both currencies."

This annual report illustrates that income determination depends upon movements in foreign currency exchange rates which have nothing to do with earnings from operations in a tax jurisdiction.

Where the percentage of business conducted in the U.S. is relatively small, changes in the value of the dollar will have a significant effect on the amount of income subject to tax. To illustrate, assume that a British corporation engaged solely in business in Great Britain establishes a U.S. subsidiary. Assume further that 90.91% of combined business is conducted in Great Britain while the remaining

9.09% is carried on in Illinois. The parent corporation earns £100 and the U.S. subsidiary earns $20 (£10 at a £1 = $2.00 exchange rate). During a tax year the value of the dollar with respect to the pound declines by 20% and the exchange rate becomes £1 = $2.40. If the exchange rate had not changed, income subject to apportionment would be £110 or $220.00; with the new exchange rate income subject to apportionment increases to $264.00, an increase of $44.00, some $24.00 more than the hypothetical income of the U.S. subsidiary. Since most foreign based taxpayers have a much greater proportion of business activity outside the United States than within, foreign based taxpayers feel the effect of exchange rate changes more acutely than domestic based taxpayers.

These problems of distortion and administrative burden are peculiar to unitary combination of foreign source income. As this Court has said:

> ". . . [t]he apportionment theory is a mongrel one, a cross between desire not to interfere with state taxation and desire at the same time not utterly to crush out interstate commerce." *Northwest Airlines, Inc. v. Minnesota,* 322 U.S. 292 at 306 (Jackson concurring) (1944).

It is respectfully suggested that this Court specifically recognize, in applying *Complete Auto Transit* standards, that the validity of a tax measured by combining foreign corporations with domestic corporations be subject to rigorous examination to protect against unfair and capricious assessment and most particularly its burdens on foreign taxpayers.

CONCLUSION

Worldwide combined reporting places an additional burden on foreign commerce not borne by domestic commerce. The problems of multiple taxation and impairment of the uniformity of federal policy are most apparent when combined reporting is applied to foreign owned entities. These difficulties still exist even with domestic owned entities engaged in worldwide commerce, and this Court can eliminate such burdens and avoid needless future litigation by confining the application of combined reporting to the boundaries of the United States. Amicus urges this Court to do so.

Respectfully submitted,

JOANNE M. GARVEY
ROY E. CRAWFORD

Attorneys for Amicus Curiae

Appendix A

HOPKINS & SUTTER
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December 2, 1981

4648-79-1

Mr. Alexander L. Stevas
Clerk
Supreme Court of the United States
Washington, D.C. 20543

Re: Chicago Bridge & Iron Company v.
Caterpillar Tractor Co., et al.
No. 81-349

Dear Sir:

As counsel for Chicago Bridge & Iron Company, appellant in the above-entitled case, I wish to advise you that we have no objection to the filing of *amicus curiae* briefs by any person or organization, whether in support of our position, opposed to it, or otherwise. We do, however, object to the granting of permission to participate in oral argument to any *amicus*.

Very truly yours,
WILLIAM P. SUTTER

WPS:jll
cc: Mr. Don S. Harnack
Mr. John D. WhiteNack

Appendix B

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December 7, 1981

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Mr. Alexander L. Stevas
Clerk
Supreme Court of the United States
Washington, D.C. 20543

Re: Chicago Bridge & Iron Company v.
Caterpillar Tractor Co., et al.
No. 81-349

Dear Sir:

As counsel for Caterpillar Tractor Co., et al., one of the appellees in the above-entitled case, I wish to advise you that we have no objection to the filing of *amicus curiae* briefs by individuals, corporations, organizations or states.

Very truly yours,
/s/ Don S. Harnack

DSH:mv

cc: Mr. William P. Sutter
Mr. John D. WhiteNack
Mr. William D. Dexter
Ms. Jean A. Walker
Ms. Joanne M. Garvey
Mr. Franklin C. Latcham
Mr. Derrick Takeuchi

Appendix C

ILLINOIS DEPARTMENT OF REVENUE

160 North LaSalle
Chicago, Illinois 60601
The Honorable Alexander Stevas
Clerk of the
Supreme Court of the United States
Washintgon, D.C. 20543

Re: No. 81-349
In the Supreme Court of the United States
Chicago Bridge & Iron Co., v.
State of Illinois, Department
of Revenue, et al., and
Caterpillar Tractor Co.
(Probable Jurisdiction Noted
Oct. 9, 1981)

Dear Sir:

This refers to the request in the copy of letter attached.

On behalf of the Illinois Department of Revenue, we hereby express that we have no objection to the filing of an amicus curiae brief, in support of the appellant, by Joanne M. Garvey of Jordan, Keeler & Seligman. FURTHER, we hereby state that we have no objection to the filing of *amicus curiae* briefs by any person or organization, whether in support of or opposed to our position, or otherwise.

Yours truly,
TYRONE C. FAHNER
Attorney General

December 4, 1981

cc: Joanne M. Garvey, Esq.
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LBF:mj
Encl.

Appendix D

Objections of Canada to State Unitary Taxation

September 26, 1980

The Honorable Allan J. MacEachen

Deputy Prime Minister and
Minister of Finance of Canada

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting States to establish its status as a religious, scientific, literary, educational or charitable organization entitled to exemption under paragraph 1 of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Con-

tracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you that the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters."

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of America and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

Appendix E

Objections of France to State Unitary Taxation

November 24, 1978

Exchange of Letters on Execution of U.S.-France Protocol to Income and Property Tax Treaty of July 28, 1967 as amended by Protocol of October 12, 1971

His Excellency
Francois de Laboulaye
Ambassador of France

[Initial paragraphs dealing with certain U. S. reservations omitted]

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(*c*) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

Appendix F

Objections of the United Kingdom to State Unitary Taxation

BRITISH EMBASSY,
Washington, D.C., June 23, 1980.

Hon. HARRY F. BYRD, JR.,
Russell Senate Office Building.
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note [copy attached] communicated to the Administration on March 25, 1980.

J. ANSON, *Minister, Economics.*

[Press release issued by the British Embassy Information Department]

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US, which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on 26 August, 1976, 31 March 1977 and 15 March

1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although the

local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention,

the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

Appendix G

Objections of European Economic Community to State Unitary Taxation

AMBASCIATA D'ITALIA.
Washington, D.C., March 19, 1980.

To the Department of State, Washington, D.C.:

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine EEC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

[Seal]

PAOLA PANSA CEDRONIO,
Ambassador of Italy.

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse

situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries."

7. The Federal Government uses the arm's-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9(4) of the Treaty, which was supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress, S 983, S 1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Goverments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Office - Sup
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JUL 31 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

BRIEF *AMICUS CURIAE* OF THE CONFEDERATION OF BRITISH INDUSTRY

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TABLE OF CONTENTS

	Page
QUESTION ADDRESSED BY AMICUS CURIAE	1
INTEREST OF AMICUS CURIAE	2
SUMMARY OF ARGUMENT	3
ARGUMENT	6
I. Formula Apportionment Applied Internationally Is Inherently Arbitrary and Extraterritorial, Thus Violating the Due Process Clause	6
II. The Worldwide Method Violates the Commerce Clause Because It Discriminates Against Foreign Commerce, and Does So Even More Seriously When Applied to a Foreign-Based Group	9
A. The Worldwide Method Discriminates Against Foreign Commerce	9
B. The Overtaxation of Foreign-Based Groups Is Much More Severe	13
C. The Compliance Burden Is Much Greater for Foreign-Based Groups	14
D. The Additional Burdens Imposed on Foreign-Based Groups Cannot Be Justified by Legitimate Interests of the States	17
III. Worldwide Combination Involving Foreign Multinationals Prevents the United States From "Speaking With One Voice."	19
A. Foreign Protests Demonstrate That the Worldwide Method Is a Very Serious Irritant to International Relations	19
B. Uniform Federal Policy Established by Treaty Precludes Contrary State Action	21
IV. Conclusion	25

TABLE OF AUTHORITIES

CASES: Page

ASARCO, Inc. v. *State Tax Commission*, 50 U.S.L.W. 4962 (U.S. June 29, 1982) 4, 8

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission* 266 U.S. 271 (1924) 6

Best & Co. v. *Marshall*, 311 U.S. 454 (1940) 10

Boston Stock Exchange v. *State Tax Commission*, 429 U.S. 318 (1977) 9

Campbell v. *Hussey*, 368 U.S. 297 (1961) 21

Chaplinsky v. *New Hampshire*, 315 U.S. 568 (1942) .. 25

Compleie Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977) 4

Dorky v. *Kansas*, 264 U.S. 286 (1924) 25

Exxon Corp. v. *Governor of Maryland*, 437 U.S. 117 (1978) 10

Exxon Corp. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) 6

F. W. Woolworth Co. v. *Taxation and Revenue Department*, 50 U.S.L.W. 4957 (U.S. June 29, 1982) 4

Hunt v. *Washington State Apple Advertising Commission*, 432 U.S. 333 (1977) 10

In re Grand Jury Subpeonas, 72 F. Supp. 1013 (S.D.N.Y. 1947) 17

Japan Line Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 3, 5, 13, 21

Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980) 6

Northwestern States Portland Cement Co. v. *Minnesota*, 358 U.S. 450 (1959) 9

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 4, 7

STATUTES AND REGULATIONS:

Cal. Rev. & Tax. Code § 23057 (Deering 1975) 25

I.R.C. § 907 13

I.R.C. §§ 951-964 16

Table of Authorities Continued

	Page
17 C.F.R. § 210.3-02	16
MISCELLANEOUS:	
Appellant's Opening Brief, *EMI Limited* v. *Bennet*, No. 80-4114 (9th Cir)	17
Briefs in Chicago Bridge & Iron Co. v. *Caterpillar Tractor Co.*, No. 81-349	*passim*
Bureau of Economic Analysis, U.S. Dept. of Commerce, Survey of Current Business, Aug. 1981	2
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22 Hansard (Parliamentary Debates) (27 April 1982)	19
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Income Tax Treaty, Dec. 31, 1975, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546	22
Internal Revenue Service Form 3646	16
Multistate Tax Commission, Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income (May 11, 1982)	10
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Sen. Exec. Rep. No. 19, Tax Convention with U.S.S.R., 94th Cong., 1st Sess. (1975), *reprinted in* 1976-2 C.B. 467	22
State Taxation of Foreign Source Income: Hearing Before the House Comm. on Ways and Means on H.R. 5076, 96th Cong., 2d Sess. (1980)	5
J. Stopford, J. Dunning & K. Haberich, The World Directory of Multinational Enterprises (1980)	14
Treaty of Friendship, Commerce & Navigation, March 27, 1956, United States-Kingdom of the Netherlands, 8 U.S.T. 2043, T.I.A.S. No. 3942	24

Table of Authorities Continued

Page

Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. (1977) 3, 10

IN THE

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On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

---

BRIEF *AMICUS CURIAE* OF THE CONFEDERATION OF BRITISH INDUSTRY

QUESTION ADDRESSED BY AMICUS CURIAE

Should not this court explicitly recognize that the application of worldwide combined reporting to *foreign*-based multinational corporate groups presents considerations substantially different from those applicable to U.S.-based groups because of the heterogeneous economic and political conditions affecting such foreign groups?[1]

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[1] All parties have consented to the filing of this brief. Copies of the written consents have been lodged with the Clerk of the Court.

INTEREST OF AMICUS CURIAE

The Confederation of British Industry ("CBI") is an independent, non party-political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organizations and trade associations that represent individual manufacturing industries; and commercial associations. CBI directly represents some 14,000 corporate entities in Great Britain and some 100,000 more through affiliated trade and employer organizations. The Confederation speaks for businesses employing over ten million persons, one half of total employment in Great Britain outside of central and local Government.

A number of CBI's members own subsidiary companies in the United States. At the end of 1980, United Kingdom direct investment in the United States was $11.3 billion, about seventeen percent of total foreign investment in the U.S., making the U.K. the second largest foreign investor in this country.[2] CBI, on behalf of its members, thus has a substantial and direct interest in State taxation of affiliates of U.K. corporations. The worldwide combined reporting method has a direct and adverse impact on CBI's members with affiliates in the United States.

The worldwide combined reporting method used by a few States is fundamentally destructive of foreign investment in the U.S. and therefore of broader trade relationships between the United States and other countries. It is an arbitrary and extraterritorial method of taxation contrary to Due Process of Law. It intrudes directly upon the Constitutional responsibility of the Federal Government to regulate foreign commerce. It interferes with an existing uniform Federal policy which is in accord with the custom of nations.

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[2] *See* Bureau of Economic Analysis, U.S. Dep't of Commerce, *Survey of Current Business*, Aug. 1981, at 47.

CBI has actively opposed the use by some States of worldwide combined reporting and has sought to eliminate such discriminatory taxation as applied to U.K. corporate groups. In its testimony in 1977 at Senate hearings on ratification of the U.K. tax treaty, CBI strongly supported an article of the treaty negotiated by the two governments (Article 9(4)) that would have prevented States from including U.K. companies and their subsidiaries in a combined report unless they were controlled by a U.S corporation.[3] A majority of the Senate voted to maintain article 9(4) intact, but the necessary two-thirds majority for treaty ratification could not be obtained. Accordingly, article 9(4) was made inapplicable to the States by a protocol to the treaty (though it remains applicable to the Federal Government). So amended, the treaty was ratified by Parliament with great reluctance, and only after vigorous debate. Since then, the U.K. Government has continued to seek relief for U.K.-owned corporate groups from the excessive burdens imposed by worldwide combined reporting.[4]

SUMMARY OF ARGUMENT

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court identified two requirements under the Commerce Clause for the validity of a State tax reaching foreign commerce. A State taxing scheme will be struck down if it "creates a substantial risk of international multiple taxation" or "prevents the Federal Government from 'speaking

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[3] *See* Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 184 (1977) (Statement of John S. Nolan on Behalf of the British National Committee of the International Chamber of Commerce and the Confederation of British Industry) [hereinafter cited as Senate Hearings].

[4] *See, e.g.*, British Embassy, Press Release, *reprinted in* Brief of Appellant, App. G., *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349 [hereinafter cited as *Chicago Bridge*].

with one voice when regulating commercial relations with foreign governments.' " As a threshold matter, the State tax must pass the four-part test set forth in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977). One of the elements of that test is that the tax not discriminate against interstate or foreign commerce. Nondiscrimination is perhaps the most basic requirement that the Commerce Clause imposes. Finally, this Court's decisions establish that a taxing scheme which is arbitrary or extraterritorial violates the Due Process Clause. *See Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920); *ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

This case presents the issue whether the worldwide combined reporting/unitary apportionment method of taxation ("worldwide method") applied by California violates the above standards. Before reaching this issue, this Court is presented with the question whether the operations of appellant and its subsidiaries constitute a unitary business. Under the elaboration of the unitary business test in this Court's recent decisions in *ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962 (U.S. June 29, 1982), and *F.W. Woolworth Co.* v. *Taxation and Revenue Department*, 50 U.S.L.W. 4957 (U.S. June 29, 1982), it seems clear that the operations of appellant's foreign subsidiaries do not constitute part of its unitary business. If this Court so finds, it will not, of course, have any occasion to reach the issues discussed in this brief.

In the case at bar, appellee Franchise Tax Board has applied the worldwide method to a multinational corporate group headed by a U.S. parent company. While the worldwide method violates the standards described above even when it is applied to a U.S.-based group, its constitutional violations are infinitely more severe when it is applied to a foreign-based

group.[5] This fact has been recognized by the Treasury Department.[6] This brief is designed to seek explicit recognition by this Court of the unique constitutional problems presented by application of the worldwide method to foreign-based corporate groups.

The worldwide method systematically overallocates income to the taxing States in the case of foreign-based groups. This effect is the key element in three constitutional violations. First, because it leads to taxation of income not earned in the taxing State, the worldwide method constitutes extraterritorial taxation in violation of the Due Process Clause. Second, because it leads to a higher average tax burden on foreign than on domestic commerce, the worldwide method discriminates against foreign commerce, in violation of the Commerce Clause. Third, by frequently subjecting to State taxation income that has already been taxed by the country in which it was earned, the worldwide method violates the Commerce Clause by leading to a substantial risk of international multiple taxation. These Due Process and Commerce Clause violations, while they may exist in any case of use of the worldwide method by the States, are extraordinarily severe when foreign-based companies are involved. Moreover, when applied to such companies, the worldwide method prevents the United States from speaking with one voice, in violation of the Commerce Clause test set forth in *Japan Line*.

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[5] As used in this brief, the terms "foreign-based multinational corporate group", "foreign-based group", and the like mean a group of corporations which are ultimately controlled by a parent company resident in a foreign country and owned predominantly by non-U.S. citizens.

[6] *See* State Taxation of Foreign Source Income: Hearing Before the House Comm. on Ways and Means on H.R. 5076, 96th Cong., 2d Sess. 7-8 (1980) (Statement of Assistant Secretary of the Treasury Donald C. Lubick).

ARGUMENT

I. Formula Apportionment Applied Internationally Is Inherently Arbitrary and Extraterritorial, Thus Violating the Due Process Clause.

This Court has upheld formula apportionment in the domestic[7] context on a number of occasions. *E.g.*, *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207, 221-223 (1980). Recently, the Court stated that "[a]lthough separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 438 (1980). This approval of formula apportionment makes practical sense in the domestic context. The considerations justifying the use of apportionment as a substitute for arm's-length accounting do not, however, apply when the task is to distinguish foreign from domestic income.

First, it is crucial to recognize that the "separate accounting" rejected by this Court in *Mobil*, *Exxon*, and earlier cases is quite different from the arm's-length accounting information available in the international context. The principal distinction is that, internationally, arm's-length accounting is policed by the Internal Revenue Service. It would not be possible in this context for a company to provide different "separate accounting" analyses to different States, since the company would be bound by the information furnished to the IRS. Moreover, the States would benefit from IRS audits of income according to the arm's-length rules, just as they benefit from other IRS audit adjustments.[8] Accordingly, international arm's-length rules lead to a much more accurate sourcing of income than can be obtained from separate accounting in the domestic context.

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[7] A case in which apportionment was applied to both foreign and domestic operations did not present for consideration the issues of distortion and discrimination presented here. *See Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

[8] *See* L. Hale & R. Kramer, State Tax Liability and Compliance Manual 46-47 (1981).

In addition, application and audit of international arm's-length rules are much more practicable than would be the use of such rules in domestic separate accounting. Domestic separate accounting would require that extensive interstate operations of a unitary business in a number of States be untangled State by State. By contrast, in the international context, the only transactions that must be tested according to arm's-length rules are those between a U.S. company and related foreign companies. The numerous transactions that a typical multinational group carries out entirely among its United States corporate members or entirely abroad need not be examined, since they would not affect the division of income between U.S. and foreign sources. Worldwide combined reporting stands in stark contrast to the relatively narrow scope of arm's-length accounting, since it requires consideration of *all* income-producing transactions of all members of the corporate group thoughout the entire world, together with the property, payroll, and sales of such members in all parts of the world.

Second, the homogeneity of the U.S. economy and the nearly universal use of very similar apportionment formulas by the States assure that apportionment of U.S. income will work fairly. Profits will in most cases bear a reasonably close relationship to the apportioning factors; and, where they do not, the excess apportioned to one State will be compensated by a lesser amount of income apportioned to other States. When applied in the international economy, however, the formula apportionment method is "inherently arbitrary," *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920), and is consequently impermissible under the Due Process Clause.

Thus, because of the divergence of economic conditions throughout the world, profits generally will not bear the same relationship to the apportionment factors in different countries. Intercountry differences can often be ascribed directly to government policy, which, by the very nature of government, will vary significantly from country to country. For example, a high level of indirect taxes on the products sold by a company in

a given country will artificially inflate the sales factor in that country. Profits as a proportion of total sales will be less than they are in low-tax countries and worldwide apportionment will, therefore, over-allocate profits to the country with higher indirect taxation. The Windfall Profit Tax produces this effect, resulting in the over-allocation of worldwide oil income to the United States.

The same will be true of the property factor in the case of a country that imposes stringent pollution controls or other production regulations that increase the cost of a company's investments without increasing profits. This Court may take judicial notice of the fact that California imposes far more severe environmental control requirements than most of the rest of the world.

In the case of the payroll factor, differing levels of employer taxes and minimum wages will, for example, lead to similar distortions. The United States, and particularly States such as California, tend to have far higher wage rates than elsewhere in the world, due in part to such regulations and taxes.

Given these types of realities, it is inherently arbitrary and irrational to allocate profits according to a formula applied to different countries in the same manner, without any recognition of these differences.

As suggested above, and as shown more particularly in Part II below, the worldwide apportionment method results, on average, in an excessive allocation of profits to the United States. It therefore leads, on a systematic basis, to State taxation of income that is not earned within the taxing State. Such extraterritorial taxation constitutes an additional violation of the Due Process Clause. *See ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

II. The Worldwide Method Violates the Commerce Clause Because It Discriminates Against Foreign Commerce, and Does So Even More Seriously When Applied to a Foreign-Based Group.

A. *The Worldwide Method Discriminates Against Foreign Commerce.*

In addition to being an impermissibly arbitrary and extraterritorial method of taxation, in violation of Due Process, the worldwide method violates the Commerce Clause because it discriminates against foreign commerce. This discrimination comes about when a State goes beyond the arm's-length income of the taxpayer to reach income earned by the taxpayer's foreign affiliates. Consider, for example, a U.K. corporation desiring to establish a subsidiary to do business in California. If California's taxing scheme has the effect, as it does, of including as taxable profits in California profits of other parts of the U.K. corporate group not carrying on business in California, or even the United States, then the California subsidiary will be taxed on a figure in excess of its own profits.[9] By contrast, a corporation operating in California alone will generally face a lighter tax load, since its tax base necessarily includes only the profits of the California corporation itself.

"No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.' " *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977), *quoting Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457 (1959). Where a State law on its face appears to be neutral as between local and interstate business, it is necessary to go beyond the letter of the statute and to inquire whether *its practical effect* is to

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[9] Whether a particular California taxpayer is so taxed will depend on the allocation factors adopted and the income of various members of the corporate group. We show below that the worldwide method, as applied to most multinationals, has the effect of overstating the income of subsidiaries operating in the taxing States.

discriminate against interstate business. *See Best & Co.* v. *Marshall*, 311 U.S. 454 (1940); *Hunt* v. *Washington State Apple Advertising Commission*, 432 U.S. 333, 348-53 (1977); *Exxon Corp.* v. *Governor of Maryland*, 437 U.S. 117, 145-48 (1978) (Blackmun, J., concurring in part and dissenting in part). If the worldwide method taxes most multinational corporations on amounts in excess of their arm's-length income earned in the United States, then it discriminates against foreign commerce, because the tax imposed is greater than that placed on domestic corporations.

The appellee has effectively admitted that the worldwide method has this effect. Mr. Kenneth Cory, as Chairman of the Franchise Tax Board and Controller of the State of California, stated that the estimated annual revenue loss to California from prohibition of the worldwide method was $125 million (in 1975 dollars).[10] A number of other States have recently confirmed that they would lose substantial revenues if arm's-length accounting were mandated.[11] If the worldwide method

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[10] *See Senate Hearings*, *supra* note 3, at 95, 167.

[11] Seven states responding to a questionnaire distributed by the Multistate Tax Commission on behalf of the Treasury Department furnished revenue loss estimates as follows: California: $500 million; Colorado: $12 million; Idaho: $16-17 million; Montana: $3 million; New York: $75 million; North Dakota: $3.5-5.5 million; and Utah: $16 million. *See* Multistate Tax Commission, *Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income* 5 (May 11, 1982). The questionnaire further asked the States to estimate what percentage of corporate taxpayers subject to the worldwide method suffered an increase in taxable income as a result of application of the method. The three States that provided a numerical estimate responded as follows: California: 75-85 percent; Colorado: probably 90 percent; and North Dakota: approximately 75-85 percent. *See id.* 5-6. Three States provided an estimate of the revenue loss that would result from denial of the worldwide method for foreign-based companies alone: California: $50 million (10 percent of the $500 million total revenue loss); Montana: $400,000 (13 percent of the total); and North Dakota: $500,000-$1,500,000 (14 to 42 percent of the total).

resulted in apportioning to the United States an amount of income equal, on average, to the income actually earned in the U.S., there would be no revenue loss from the use of arm's-length accounting as opposed to worldwide apportionment.[12] The necessary implication of the estimates of substantial revenue losses is that the worldwide method, as applied to most taxpayers, reaches income that, according to arm's-length accounting, is earned outside the State. As explained above, this means that foreign commerce is discriminated against.

Estimates by the States that the worldwide method produces substantially more revenue than arm's-length accounting are corroborated by statistics that show a substantial divergence in average wage costs between the U.S. and other countries. Except for a handful of European countries, average wage costs are lower throughout the world than in the United States.[13] There is uncontradicted testimony in the record below that these lower costs are associated with higher profit rates abroad. In general, the expected and actual return on investment is lower in the United States than in other countries, particularly less developed countries. *See* R.T. 9-47. An important reason why multinationals seek higher rates of return outside the United States is the riskiness of investing in countries with governments that are less stable than government in the United States. Because of the greater profits per

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[12] These revenue losses cannot be ascribed by the States to alleged manipulation of international transactions by the companies involved and inability of the States to police the arm's-length method. The companies involved in virtually all instances are large publicly-held companies which are intensively audited in their international transactions by the Internal Revenue Service. The financial statements of such companies are audited by independent certified public accountants, and differences between the financial statements and Federal corporate income tax returns are identified on the returns.

[13] *See, e.g.*, Brief of Appellant at 41 n. 13, *Chicago Bridge, supra;* Brief of National Association of Manufacturers as Amicus Curiae 6-7 (Table I), 8 (Table II), *Chicago Bridge, supra.*

unit of property, payroll, and sales in foreign countries, the worldwide apportionment method generally understates the income attributable to operations abroad.

Similarly, over-allocation occurs because of the income base to which worldwide apportionment is applied. Taxable income by U.S. standards differs very substantially from income as determined in the balance of the world in ways that tend to over-allocate income to the U.S. in the case of foreign-owned groups. The U.S. income base, generally adopted by States such as California, allows special deductions such as the Accelerated Cost Recovery System, percentage depletion, the LIFO inventory convention, and other allowances for economic or social reasons, as opposed to pure income measurement. While a U.S.-owned group may be able to convert its worldwide operations to U.S. income tax standards, a foreign-owned group simply cannot do so as a practical matter. The foreign group may have hundreds of foreign subsidiaries operating in scores of foreign countries with accounting personnel completely unfamiliar with these unique U.S. tax allowances. The foreign-owned group ends up having its allocated worldwide income consist of—(1) its worldwide income earned outside the U.S. determined from its financial statements (determined without all of the foregoing allowances), plus (2) its U.S. income determined by U.S. tax standards (with all of such special allowances). The result inevitably is an over-allocation of worldwide income to States in the U.S.

Another such example arises with respect to international oil operations. Many oil-producing countries require payment of enormous "taxes" at rates far in excess of customary corporate income tax rates. These taxes substitute for, or are economically equivalent to, economic rents for the use of land and mineral rights owned by these governments. The United States has complex provisions to limit the foreign tax credit for

these payments.[14] The exactions, though royalties to some extent in substance, are imposed by the foreign government as taxes and generally are not deductible in determining taxable income for State income or franchise tax purposes. Since most of the world's oil production is now outside the United States, particularly in the case of foreign-owned oil companies, the result of worldwide apportionment is severely to over-allocate income to States of the U.S.

The effective taxation of income earned by related foreign corporations resulting from the worldwide method also creates a substantial risk of international multiple taxation, in violation of *Japan Line*. Where the income has already been taxed by the country where it was earned, imposition of a State tax creates an impermissible multiple tax burden.

As described in Sections B-D below, the worldwide method results in a greater degree of overtaxation and imposes more severe compliance burdens when applied to foreign-based groups. The considerations described below are relevant in determining whether the taxing scheme results in sufficiently systematic and severe discrimination against foreign commerce to be invalidated. This case on its facts does not present the additional burdens peculiar to foreign-based groups. Accordingly, if this Court should find to any extent that the worldwide method as applied to U.S.-based groups does not discriminate against foreign commerce, the Court should explicitly recognize that such finding does not preclude a contrary determination with respect to foreign-based groups because of their differing circumstances.

B. *The Overtaxation of Foreign-Based Groups Is Much More Severe.*

The majority of the operations of U.S.-based multinationals are located in the United States. Conversely, most of the operations of foreign-based multinationals are located

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[14] *E.g.*, I.R.C. § 907.

abroad.[15] This is a critical distinction. The smaller U.S. presence of foreign-based firms heightens the degree of discrimination when the worldwide method is applied to them. For example, assume that foreign factors are, on average, ten percent too low,[16] and that a U.S.-based group has two-thirds of its factors here, the converse being the case for a foreign-based group. On these rather conservative assumptions, the discrimination against foreign commerce is *twice* as severe when the worldwide method is applied to a foreign-based group.[17]

C. *The Compliance Burden Is Much Greater for Foreign-Based Groups.*

It is well established that States may tax the domestic operations of U.S. corporations on the basis of apportionment formulas that take property, payroll, and sales in the various States into account. Because U.S.-based multinationals must therefore in any event maintain property, payroll, and sales data

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[15] For only 32 of the 195 U.S.-based companies listed in Table A of *The World Directory of Multinational Enterprises* did overseas subsidiary sales account for 40 percent or more of worldwide sales (see Table B of the *Directory*). On average, sales of overseas subsidiaries of those of the 430 *Directory* firms that are based in the U.S.A. were about 33 percent of worldwide sales in 1978 (Table 13). On average, total sales of subsidiaries outside the home country were 51 percent of world-wide sales for Canadian-based companies and 42 percent for European-based companies in 1978. Sales of U.S. subsidiaries were necessarily some fraction of these latter amounts. *See* J. Stopford, J. Dunning & K. Haberich, *The World Directory of Multinational Enterprises* (1980).

[16] In other words, assume that profits per unit of property, payroll, and sales are ten percent higher abroad than in the United States.

[17] Suppose that a U.S.-based group earns $200 at home and $110 abroad. Its property, payroll, and sales are each 200 at home and 100 abroad. Under the arm's-length method, the group's U.S. income is $200. Under the worldwide method, two-thirds of the group's total $310 income would be apportioned to the U.S., namely $206.67. U.S. income is therefore overstated by $6.67, or 3.33 percent. The reason

with respect to their domestic operations, which, as noted above, generally constitute a majority of total operations, extension of the apportionment formula to include their worldwide operations does not usually create an extraordinary additional compliance burden. By contrast, application of worldwide formula apportionment imposes a tremendously costly, if not impossible, record-keeping burden upon most foreign multinationals, because worldwide property, payroll, and sales data would not otherwise have to be developed. Even if some of these data had to be developed for other purposes, they would not generally be expressed in U.S. dollars or according to U.S. accounting principles. Restatement of any property, payroll, and sales data maintained by member companies of a foreign-based group is often a massive undertaking. Development of the property factor, which must be based on historic cost at historic exchange rates of all assets in service, can be well-nigh impossible.[18]

A corporate group controlled by a U.S. parent maintains consolidated financial statements in U.S. dollars and according to U.S. accounting principles in reporting to its shareholders.

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for the overstatement is that foreign profits per unit of property, payroll, and sales are ten percent greater than in the U.S.

Now consider a foreign-based group with the same ten-percent differential in profitability per unit of property, payroll, and sales. It earns $100 in the U.S. and $220 abroad, and its property, payroll, and sales are each 100 in the U.S. and 200 abroad. The worldwide method allocates one-third of the group's total $320 income, or $106.67, to the United States. This is an overstatement of the group's U.S. income of 6.67 percent, compared with the 3.33-percent overstatement in the case of the U.S.-based group. Thus, the degree to which U.S. income is overstated is twice as great for the foreign-based group.

[18] Development of the property factor would require translating the original acquisition cost of each asset owned by members of the multinational group into U.S. dollars at the exchange rates prevailing on the date of acquisition and recomputing depreciation to date on this basis.

The SEC requires public disclosure of these data.[19] In addition, information returns setting forth the income of foreign subsidiaries must be filed with the IRS.[20] Some of this income may be directly taxable to the U.S. parent as "Subpart F" income[21] and, accordingly, all of such income is subject to IRS audit.

Any such data maintained by a foreign-based multinational will, however, be based on foreign accounting principles and will be expressed in foreign currency. Currency translation poses extraordinarily burdensome problems. Because of the fluctuation of currency rates over the course of a year, a simple translation of the bottom-line amount into U.S. dollars will not correctly express the dollar equivalent of income earned by different subsidiaries with differing taxable years in a number of foreign currencies. In practical terms, the impossibility in many cases of making the required currency and accounting adjustments forces foreign-based groups to use book income figures in the apportionment formula. As noted above,[22] this severely disadvantages foreign-based taxpayers.

U.S. subsidiaries of foreign-based companies often experience extreme difficulties in obtaining the information necessary to comply with the worldwide method. When a State imposes the worldwide method on a U.S. parent, the parent can order its subsidiaries to provide the required data. By contrast, a U.S. corporation controlled by a foreign parent may be unable to convince its parent and sister foreign corporations to develop the extensive data needed to compute the tax of the U.S. subsidiary under the worldwide method. A request for information by a U.S. subsidiary may be rejected by its foreign parent, especially where the request is in aid of a method of taxation contrary to internationally accepted principles of

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[19] *See* 17 C.F.R. § 210.3-02.

[20] *See* Internal Revenue Service Form 3646.

[21] *See* I.R.C. §§ 951-964.

[22] P. 12.

taxation. The foreign parent may even be prohibited by foreign law from disclosing the information, as when the information relates to a defense contract.[23]

If a U.S. subsidiary is unable to obtain the required information, the taxing State should not be allowed to penalize it for the inaction of the related foreign corporations. Provided that these corporations do not do business in the United States, the State would under these circumstances have no jurisdiction to compel them to produce the required documents. *E.g., In re Grand Jury Subpoenas*, 72 F. Supp. 1013, 1019 (S.D.N.Y 1947). The prospect of such jurisdictional challenges to a State's request for information reveals the essentially extraterritorial nature of the worldwide combined reporting method as applied to foreign-based groups.

D. *The Additional Burdens Imposed on Foreign-Based Groups Cannot Be Justified by Legitimate Interests of the States.*

The additional burdens imposed by the worldwide method cannot be justified by difficulties in administering the arm's-length method, as the States argue in relation to U.S.-based groups. Thus, in the case of U.S.-based multinational groups, the States contend that even sophisticated policing of the arm's-length standard fails to take fully into account the intangible and elusive benefits provided by the parent company to its subsidiaries, such as technical know-how, managerial services, and centralized information. Omission of a proper charge for such benefits understates the income of the parent company. The overstatement caused by the worldwide method may compensate for this omission to some degree. When the worldwide method is applied by a State to a U.S. subsidiary of

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[23] In the *EMI* case, disclosure of information relating to defense contracts was sought by California but was protected from disclosure by the U.K. Official Secrets Act. *See* Appellant's Opening Brief 5-6, *EMI Limited* v. *Bennett*, No. 80-4114 (9th Cir.).

a foreign-based group, however, this element of compensation for an omitted arm's-length charge is entirely absent. Indeed, omission of a charge for intangible benefits provided by the foreign parent *overstates* the income of the U.S. subsidiary as computed on an arm's-length basis.[24]

Similarly, while a U.S.-controlled group may often sell products produced by it in whole or in part in the United States to subsidiaries in foreign countries with low income tax rates, both less developed countries and countries such as Switzerland or Panama, so that the policing of intercompany transactions may be of major importance, this is ordinarily not the case with respect to a foreign-based group with a U.S. subsidiary. Foreign groups operating in the U.S. are generally selling products produced by them either in the U.S. or in their home country, an industrialized nation, such as the U.K., Canada, Japan, West Germany, France, Italy, or Sweden, which are countries that also have high corporate income tax rates. In such instances, a foreign-based company generally has no incentive to seek to allocate profits to its home country as opposed to the United States. Moreover, both the home country and the U.S. Internal Revenue Service carefully monitor the arm's-length pricing of intercompany transactions. As noted above,[25] the resulting audit information is available to the States.

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[24] If a foreign parent were to *overcharge* for services, the transaction would be out in the open and could be audited according to arm's-length rules. The problem for arm's-length auditing occurs when there is no charge at all, in which case the transaction would leave no paper trail for an auditor.

[25] P. 6.

III. Worldwide Combination Involving Foreign Multinationals Prevents the United States From "Speaking With One Voice."

A. *Foreign Protests Demonstrate That the Worldwide Method Is a Very Serious Irritant to International Relations.*

Individual States prevent the United States from speaking with one voice to foreign countries when their actions invite protests and the possibility of retaliation by foreign governments. A number of trading partners of the United States have recently voiced strong complaints as to State use of the worldwide method.[26] Retaliation against U.S. companies has been discussed in Parliament as a possible response to use of the worldwide method by the States.[27] It is noteworthy that these protests have been confined to application of this method to U.S. subsidiaries of corporate groups based in the foreign country involved.[28] Article 9(4) of the proposed U.S.-U.K.

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[26] *See* Brief of Appellant at Appendices E (E.E.C.), F (Italy), G (U.K.), H (Netherlands), I (France), J (Canada), *Chicago Bridge, supra*. The Government of The Kingdom of the Netherlands has also filed a memorandum as amicus curiae in *Shell Petroleum, N.V.* v. *Graves*, No. C 81-4302 (N.D. Cal. 1981).

[27] *See* 22 Hansard, Parliamentary Debates (House of Commons) 823-28 (27 April 1982).

[28] *See* Brief of Appellee at 24-27, *Chicago Bridge, supra*.

For example, a Note presented to the State Department by the British Embassy on behalf of the ten EEC Governments stated: "Our Governments are concerned about the application to U.S. subsidiaries of foreign companies of the unitary basis of taxation . . ." British Embassy, Note No. 211 (30 October 1981), *reprinted in* Memorandum for the United States as Amicus Curiae at 4a, 5a, *Chicago Bridge, supra*.

A Note from the Canadian Embassy referred to "the so-called 'unitary tax apportionment' method used by certain States of the United States to allocate income to Unites States offices and subsidiaries of non-United States international companies. The Canadian Government continues to be of the view that this method results

Income Tax Treaty forbidding the worldwide method was likewise confined to U.S. subsidiaries of U.K. companies.[29]

It is self-evident why a foreign country is concerned when a State in effect taxes a U.S. subsidiary not only on its own income but also on non-U.S. income of other members of the corporate group based in that foreign country. Even though the subsidiary is in the first instance responsible for payment of the tax, the foreign parent suffers a direct harm by reason of the reduction in the value of its investment. When applied to a foreign-based group, the burden of the worldwide method accordingly falls on the foreign parent corporation and its foreign shareholders.

Foreign outrage at the worldwide method has already seriously interfered with the Federal Government's treaty negotiation process. The worldwide method has been an issue in several recent treaty negotiations, including treaties with the U.K., France, and Canada.[30] In the case of the U.K. treaty, after the Senate had failed to prohibit use of the worldwide method by the States, the United States made a number of concessions in the Third Protocol to the treaty to induce the U.K. to accept the treaty without this restriction.[31] The impact of concessions of this type is naturally not limited to the particular States employing the worldwide method, but falls on U.S.

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in inequitable taxation and imposes excessive administrative burdens on non-United States international companies doing business in those States." Canadian Embassy, Note No. 692 (Dec. 22, 1981), *reprinted in id.* 8a.

[29] An earlier version of this article would have forbidden inclusion of any U.K. company (or a subsidiary of a U.K. company) in worldwide combination, even if the parent were not U.K. based, but the U.K. Government gave up this point, its chief concern being with the taxation of U.K.-based multinationals.

[30] *See* Brief of Appellant, at App. G, I, J, *Chicago Bridge*, *supra*.

[31] *See id.* App. K.

citizens in all the States. It is axiomatic that action by individual States that places the Nation at a disadvantage in its relations with other Nations cannot be constitutionally tolerated.

B. *Uniform Federal Policy Established by Treaty Precludes Contrary State Action.*

Under the Commerce and Supremacy Clauses, State legislation is constitutionally pre-empted where Federal uniformity is required or where Congress has occupied the field by a comprehensive regulatory scheme. *E.g.*, *Campbell* v. *Hussey*, 368 U.S. 297, 300-03 (1961). In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court established that a State taxing scheme is subject to more exacting constitutional scrutiny if it impinges on foreign—as opposed to interstate—commerce. Applying this scrutiny, the Court found that the existence of treaties provided evidence of the need for Federal uniformity. In that case, a State property tax on containers used in foreign commerce was struck down. The United States was a party to the Customs Convention on Containers, which granted such containers duty-free entry. In addition, the U.S.-Japan Income Tax Treaty exempted from tax income derived from the use of such containers. The Court found the Customs Convention reflective of a national policy to remove impediments to the use of containers in international commerce, and struck down the California tax as violative of this policy. 441 U.S. at 453. In so doing, the Court relied on the fact that the California tax created "an asymmetry in international maritime taxation operating to Japan's disadvantage." *Id.* Japan did not tax American-owned containers. *Id.*

In this case, the expression of Federal policy and the consequent need for uniformity are even stronger than in *Japan Line*. With one understandable exception, all of the bilateral income tax treaties in force between the United States and other countries would prevent the United States from doing

what California seeks to do here.[32] This uniform Federal policy is echoed by the practice and policy of other countries and international organizations. It is beyond cavil that the scheme employed by a handful of States, headed by California, creates an "asymmetry" in the international scheme of business taxation.

Federal policy preventing worldwide apportionment is uniformly embodied in the income tax treaties of the United States, in substantially identical terms in each. These provisions have been part of this country's income tax treaty scheme for fifty years, ever since the first income tax treaty signed by the United States.[33] For example, the Income Tax Treaty, Dec. 31, 1975, United States-United Kingdom, art. 7, para. 1, 60 Stat. 1377, 1381, T.I.A.S. No. 1546, prevents the United States from taxing the income of a U.K. corporation unless the corporation has a "permanent establishment" in the United States. "Permanent establishment" means a fixed place of business. A subsidiary corporation may be, but is generally not, a permanent establishment of the parent. If the U.K. corporation does have a permanent establishment, the United States is restricted to taxing the profits "attributable" to the permanent establishment. The profits attributable to the permanent establishment are "the profits which it might be expected to make if it were a distinct and separate enterprise

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[32] The U.K. treaty is discussed below. The provisions of the remaining 24 treaties which prevent application of the worldwide method to a U.S. subsidiary of a foreign parent are listed at Appendix A. The one exception is the treaty with the Soviet Union. The Senate Foreign Relations Committee Report on that treaty noted that it omitted many of the standard provisions found in other income tax treaties. "It is probable that this difference is attributable to the contrasting political and economic systems of the two countries. U.S.S.R. nationals are not permitted to hold investments in foreign countries. . . ." Sen. Exec. Rep. No. 19, Tax Convention with U.S.S.R., 94th Cong., 1st Sess. (1975), *reprinted in* 1976-2 C.B. 467, 468.

[33] *See* Income Tax Treaty, United States-France, April 27, 1932, art. IV, T.S. 885, 49 Stat. 3145.

engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment." Art. 7(2). This is an expression of the arm's-length standard.

Thus, if a U.K. corporation operated in the United States through a permanent establishment such as a branch, the United States would clearly be prevented by treaty from taxing the branch according to formulary apportionment. If the permanent establishment took the form of a subsidiary corporation, the same result would obtain. The United States could tax only the profits properly attributable to the subsidiary, namely its arm's-length income. Finally, if the subsidiary were *not* a permanent establishment of the parent, and the parent had no permanent establishment in the United States, the United States could not tax the subsidiary on any of the income of the parent. Such taxation would violate the basic rule that the income of a foreign corporation that has no permanent establishment in the United States is exempt from United States tax. Formulary apportionment that resulted in taxing to the subsidiary an amount in excess of its arm's-length income would constitute such a violation.[34]

The uniform Federal policy precluding State use of the worldwide method is also evidenced by the numerous treaties of Friendship, Commerce, and Navigation ("FCN treaties"). In general, the FCN treaties prohibit imposition on foreign companies or their U.S. subsidiaries of taxes or compliance requirements that are unreasonable or more burdensome than those imposed on U.S. corporations. These treaties also prohibit taxation of U.S. subsidiaries on the basis of income in excess of that reasonably allocable to such corporations under

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[34] This result is reinforced by art. 9(4) of the U.S.-U.K. Treaty. This article was originally intended to apply to the States, but such application was withdrawn when the U.S. Senate refused to accept it. The article's prohibition of combined reporting, even though superfluous in light of article 7, was retained in a form applicable to the U.S. and the U.K. but not to their political subdivisions.

internationally-accepted principles.[35] The FCN treaties apply directly to the States, and they prohibit worldwide combined reporting as applied to subsidiaries of companies headquartered in countries with which the United States has entered into an FCN treaty. The United States has not entered into an FCN treaty with the United Kingdom. Although U.K. companies cannot therefore directly rely on an FCN treaty, the combination of the FCN and income tax treaties constitutes a pervasive scheme of Federal regulation of the taxation of U.S. subsidiaries of foreign companies that precludes inconsistent State taxing schemes, such as the worldwide method, with respect to companies of all foreign countries.

The uniform Federal policy expressed in the tax and FCN treaties is in complete harmony with the international acceptance of the arm's-length standard as the proper method of taxation. *See generally* Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises* (Paris, July 1979). In sum, the Federal government would violate its treaty obligations and contravene internationally accepted principles of tax administration if it adopted the unitary method with regard to foreign-based multinational groups. Both our treaty partners and the Treasury Department have stated that application of the worldwide method to foreign-based groups by the States violates the spirit of our income tax treaties.[36] Under *Japan Line*, such State creation of "an asymmetry in the international tax structure," 441 U.S. at 450, may not be tolerated.

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[35] *E.g.*, Treaty of Friendship, Commerce and Navigation, March 27, 1956, United States-Kingdom of the Netherlands, art. I, VI, XI, 8 U.S.T. 2043, T.I.A.S. No. 3942.

[36] *See* Brief of Appellant, at App. L-1, L-3, *Chicago Bridge*, *supra* (Letter from Treas. Sec'y William Simon to Senator Burdick); *id.* at App. M-1, M-8 to 9 (Statement of Asst. Sec'y Laurence N. Woodworth).

IV. Conclusion.

In deciding the case at bar, this Court should explicitly recognize the distinctions between U.S.-based and foreign-based multinationals. If this Court were to decide that the unitary method may in some cases be constitutionally applied to U.S.-based corporate groups, the opinion of the Court should very clearly indicate that it does not prejudice a challenge to this taxing scheme on the part of foreign-based groups.

When presented with a foreign-based taxpayer, the Court will properly have before it the question whether the worldwide method may constitutionally be applied to such a taxpayer and, further, whether, if such application is invalid, the statute should be struck down altogether or should be considered severable. Severability is a question of State statutory construction, not Federal law, so the answer may vary according to the State taxing scheme. *See Dorky* v. *Kansas*, 264 U.S. 286, 290 (1924). *E.g.*, *Chaplinsky* v. *New Hampshire*, 315 U.S. 568, 572 (1942). In the case of California, it seems clear that if this Court holds that the worldwide method may not be applied to foreign-based groups, such holding would not affect the applicability of such method to U.S.-based groups. *See* Cal. Rev. & Tax. Code § 23057 (Deering 1975).

Respectfully submitted,

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Counsel for The Confederation of British Industry

Dated: July 31, 1982.

(Appendix follows)

APPENDIX A

The United States has income tax treaties in force with twenty-six countries. All but one of these treaties prohibit the United States from taxing the profits of a foreign corporation unless the corporation has a "permanent establishment" in the United States. In addition, certain treaties, designated herein as Type 1 treaties, limit the United States to taxing income attributable to the permanent establishment, plus in some cases certain related income. This limitation requires a determination of what income is attributable to the permanent establishment. These treaties uniformly specify that the standard for determining the amount of income that is attributable to the permanent establishment is the *arm's-length* standard. They are listed below, and the articles that limit taxation to the income of a permanent establishment and define such income according to the arm's-length standard are referenced.

The other type of treaty, which we designate as Type 2, allows the United States to tax a corporation's entire income derived within the United States, provided that the corporation has a permanent establishment here. There is thus no occasion to define what income is attributable to the permanent establishment. These treaties do, however, mandate use of the arm's-length standard for allocating income between related corporations. In the case of Type 2 treaties, also listed below, the referenced articles are those that prohibit U.S. taxation of a foreign corporation that does not maintain a permanent establishment in the United States; and that mandate the arm's-length standard in determining the incomes of related taxpayers.

In sum, all the income tax treaties currently in force, with the exception of the U.S.-U.S.S.R. treaty, embody the arm's-length standard.

Type 1

Income Tax Treaty, October 25, 1956, United States-Austria, art. II, III, para. 2, 8 U.S.T. 1699, 1701, T.I.A.S. No. 3923.

Income Tax Treaty, July 9, 1970, United States-Belgium, art. VII, para. 1, 2, 23 U.S.T. 2687, 2695, T.I.A.S. No. 7463.

Income Tax Treaty, March 4, 1942, United States-Canada, art. I, III, para. 1, 56 Stat. 1399, 1400, T.I.A.S. No. 1983.

Income Tax Treaty, March 6, 1970, United States-Finland, art. VIII, para. 1, 2, 22 U.S.T. 40, 53 T.I.A.S. No. 7042.

Income Tax Treaty, July 28, 1967, United States-France, art. VI, para. 1, 2, 19 U.S.T. 5280, 5282, T.I.A.S. No. 6518.

Income Tax Treaty, July 22, 1954, United States-Germany, art. III, para. 1, 2, 5 U.S.T. 2768, 2778, T.I.A.S. No. 3133.

Income Tax Treaty, February 20, 1950, United States-Greece, art. III, para. 1, 2, 5 U.S.T. 47, 57, T.I.A.S. No. 2902.

Income Tax Treaty, February 12, 1979, United States-Hungary, art. VII, para. 1, 30 U.S.T. 6361, 6369, T.I.A.S. No. 9560.

Income Tax Treaty, May 7, 1975, United States-Iceland, art. VIII, para. 1, 2, 26 U.S.T. 2004, 2042, T.I.A.S. No. 8151.

Income Tax Treaty, May 21, 1980, United States-Jamaica, art. VII, para. 1, 2, T.I.A.S. No. 10206, 10207.

Income Tax Treaty, March 8, 1971, United States-Japan, art. VIII, para. 1, 2, 23 U.S.T. 967, 982, T.I.A.S. No. 7365.

Income Tax Treaty, June 4, 1976, United States-Korea, art. VIII, para. 1, 2, 30 U.S.T. 5253, 5272, T.I.A.S. No. 9506.

Income Tax Treaty, April 29, 1948, United States-Netherlands, art. III, para. 1, 2, 62 Stat. 1757, 1758, T.I.A.S. No. 1855.

Income Tax Treaty, October 8, 1974, United States-Poland, art. VIII, para. 1, 2, 28 U.S.T. 891, 904, T.I.A.S. No. 8486.

Income Tax Treaty, December 4, 1973, United States-Romania, art. VII, para. 1, 2, 27 U.S.T. 165, 174, T.I.A.S. No. 8228.

Income Tax Treaty, March 25, 1939, United States-Sweden, art. II, III, 54 Stat. 1759, 1760, T.I.A.S. No. 5656.

Income Tax Treaty, January 9, 1970, United States-Trinidad and Tobago, art. VIII, para. 1, 2, 22 U.S.T. 164, 173, T.I.A.S. No. 7047

Income Tax Treaty, December 13, 1946, United States-Union of South Africa, art. V, para. 1, art. VII, 3 U.S.T. 3821, 3826, T.I.A.S. No. 2510

Income Tax Treaty, April 16, 1945, United States-United Kingdom, art. VII, para. 1, 2, 60 Stat. 1377, 1381, T.I.A.S. No. 1546

Type 2

Income Tax Treaty, May 14, 1953, United States-Australia, art. III, para. 2, 4, 4 U.S.T. 2264, 2267, T.I.A.S. No. 2879.

Income Tax Treaty, September 13, 1949, United States-Ireland, art. III, para. 1, 2, 2 U.S.T. 2303, 2307, T.I.A.S. No. 2356.

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Income Tax Treaty, May 24, 1951, United States-Switzerland, art. III, para. 1, 3, 2 U.S.T. 1751, 1755, T.I.A.S. No. 2316.

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No. 81-523

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

vs.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court of Appeal of the State of California for the First Appellate District

Brief of EMI Limited and Capitol Industries-EMI, Inc. as Amici Curiae in Support of Appellant Container Corporation of America On Merits of the Case

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TABLE OF CONTENTS

	Page
Interest of Amici Curiae	1
Summary of argument	2
Argument	4
Introductory	4
I. The use of the arm's length method of determining the income which a Nation has authority to permit its subdivisions to tax, and the avoidance of double taxation through credits, have both become principles of international law, precluding the use by the states of combined apportionment formulae against those corporations entitled to rely on international law	5
II. The history of the failure of the Confederacy and the substitution of the Constitution shows that the tolerance of some state burdens on interstate commerce does not extend to burdens on foreign commerce	21
III. State taxation of domestic multinational groups by a method more onerous than the method international law requires be used in taxing foreign multinational groups is a burden on foreign commerce	23
Conclusion	30
Appendix A	A1
Appendix B	A2

TABLE OF AUTHORITIES CITED

Cases

Page

Asarco, Inc. v. Idaho Tax Commission, No. 80-2015, Oct. Term, 1981 ..... 28, 29

Baker v. Carr, 369 U.S. 186 (1972) 11

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Chicago & S. Airlines v. Waterman SS Corp., 333 U.S. 103, 111 (1948) 3, 16, 18

Chicago Bridge and Iron Co. v. Caterpillar (No. 81-349, Oct. Term 1981) 29

Chy Lung v. Freeman, 92 U.S. 275 (1876) 10

Dames & Moore v. Regan, ... U.S. ....., 69 L.Ed 2nd 918 (1981) 11, 16

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980) 29

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Haig v. Agee, ... U.S. ....., 69 L.Ed. 2d 640 (1981) 16, 17

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 2, 3, 4, 5, 10, 13, 21, 23, 25, 27

Kolovrat v. Oregon, 366 U.S. 187 (1961) 14

McCulloch v. Marineros de Honduras, 372 U.S. 10, 21 (1963) 8, 26

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Page

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Schechter v. United States, 295 U.S. 495 (1935) 16
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Sumitomo Shoji America, Inc. v. Avagliano, No. 80-2070 and 81-24, October Term, 1981, decided June 15, 1982 ..... 4, 6, 20
The Paquete Habana, 175 U.S. 677 (1900) 2, 7
United States v. Belmont, 301 U.S. 324 (1937) 3, 10, 14, 17
United States v. Curtiss Wright Export Corp., 299 U.S. 319 (1936) 3, 10, 16, 17, 19, 24
United States v. Pink, 315 U.S. 203 (1942) 17
United States v. Shaughnessy, 338 U.S. 537 (1950) 11, 16
Zschernig v. Miller, 389 U.S. 429, 440 (1968) 26

Constitution

United States Constitution, Article I, Sec. 8, cl. 3 ..... 2, 4, 5, 21, 23, 26, 27, 28
Article I, Section 8, cl. 10 14
Article VI, Section 2 14
Article VI, cl. 2 3

Statutes

Internal Revenue Code, Sec. 482 14
Internal Revenue Code, Sec. 901 20
Statute of the International Court of Justice, Section 38(1) 2, 7, 8, 12
Statute of the World Court, Section 36 ..... 2, 7

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	Page
Restatement of Foreign Relations Law, Second:	
Sec. 1	2, 7, 8
Sec. 27	6
Sec. 30	6
Sec. 172	6
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Section 1	2, 7, 8
Section 30	6
Section 102	7, 8, 12
Section 132	3, 12
Section 135(1)	14
Section 216	6, 8
Section 411	9, 12, 13
Section 412	13
Section 412(1)(c)	5, 9, 12
Section 413	9, 12, 13, 20
Section 418	6
Section 418(4)	6
James Madison, Preface to Debates in the Convention of 1787, set forth in 3 Farrand, op. cit., Appendix CCCCI, 539, 547-548	22
The Federalist XI (Madison)	22
The Federalist XLIV (Jay)	22
Model Income Tax Conventions	20, 21
Curtis, History of the Constitution of the United States (1854, Harper and Brothers, N.Y.) 148, 179-180, 276	22
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CONTAINER CORPORATION OF AMERICA,
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VS.

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On Appeal From The Court of Appeal
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for the First Appellate District

Brief of EMI Limited and Capitol Industries-EMI, Inc.
as Amici Curiae in Support of
Appellant Container Corporation of America
On Merits of the Case

A letter from counsel for each party, consenting to the filing of this brief, is on file in the Office of the Clerk.

EMI Limited, one of the amici curiae, was granted leave to file and did file an amicus brief in support of jurisdiction as sought by Container Corporation of America. The instant brief addresses the merits, and presents arguments not offered in the prior brief.

INTEREST OF AMICI CURIAE

EMI Limited (hereinafter EMI), is a United Kingdom corporation, which does not have a permanent establishment in the United States, under the United States-United Kingdom Tax Convention, and which does not do business in the United States. EMI has subsidiaries which operate in the United Kingdom and more than 40 other countries, including the United States. Most of the corporations which operate in countries foreign to the United Kingdom are exclusively in the business of recording music or manufacturing and selling recorded music, principally on record disc, but also on tape or cassette. In the United Kingdom EMI subsidiaries conduct a wide range of manufacturing, retail and service businesses, including defense contract work.

EMI has a United States subsidiary, Capitol Industries-EMI, Inc., which in turn has a subsidiary domiciled in Los Angeles, California, which records music, manufactures records, and sell records at wholesale under the name Capitol Records, Inc. Capitol Industries-EMI, Inc., has filed California Franchise Tax returns of income, reporting its income on the Unitary basis, combining its operation inside of California with those outside of it, including those of its subsidiaries. It has not filed its California Franchise Tax return income combining itself with its parent corporation, EMI, or EMI's other subsidiaries. The California Franchise Tax Board has administratively combined Capitol Industries-EMI with EMI and its other subsidiaries, on a "music only" basis, and assessed it accordingly.

EMI has brought an action for an injunction and declaratory relief in the federal district court which that court dismissed on jurisdictional grounds. On appeal, the Ninth Circuit Court of Appeals in EMI, Limited v. Bennett, et al., No. 80-4114, reversed and remanded to the district court for consideration of the merits. Capitol Industries-EMI, Inc. has also brought suit in the federal court, and in the companion case its appeal is before the Ninth Circuit Court of Appeals under the style Capitol Industries-EMI, Inc. v. Bennett, et al., No. 80-4113, on petition for rehearing of the jurisdictional point.

A principal contention of both EMI and Capitol Industries-EMI, Inc., is that the unitary combination which California seeks to impose on the two companies is an imposition on and attempted regulation of foreign commerce, and is barred by the United States Constitution, Article I, Sec. 8, cl. 3, as interpreted in this Court in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979).

While there may be constitutional limitations against state taxation of the income of a United Kingdom corporation not having a permanent establishment in the United States not presented in the case at bar, the Court's review of this case and reversal of the California decision may well dispose of EMI's case as well as the case at bar.

SUMMARY OF ARGUMENT

1. Internationally accepted custom is one source of international law. Sec. 38(1), Statute of the International Court of Justice; Sec. 36, Statute of the World Court; *Sears v. The Scotia,* 14 Wall. (81 U.S.) 170 (1872); *The Paquete Habana,* 175 U.S. 677 (1900); Restatement of the Foreign Relations Law of the United States, Second, Sec. 1, Comment C. Every treaty on the subject in force, every model treaty both of this Government and of the United Nations and of other international agencies, provides for use of the arms length method in allocating income to source. International practice is to use it between countries without bi-lateral tax treaties. The Solicitor General,

who represents the government in this court, responding to the requests from the Secretaries of State, Treasury and Commerce, and the United States Trade Representative, has informed the Court in his amicus brief in the Chicago Bridge & Iron case, no. 81-349, October Term, 1981, that the United States Government recognizes that the use of the arms length method is international custom. It is, therefore, international law.

The Executive speaks for the United States in our foreign relations, the conduct of which is not entrusted to this court [*Chicago & S. Airlines v. Waterman SS Corp.*, 333 U.S. 103, 111 (1948)] or to Congress [*United States v. Curtiss Wright Export Corp.*, 299 U.S. 319 (1936)]. His statement that the United States accepts the universality between nations of the arms length custom is a statement of the international law this nation accepts, and respects. (Restatement of Foreign Relations Law, Draft Revision, Sec. 132, Comment C.)

The states are, of course, bound by international law as fully as is the Nation. *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964); Article VI, cl. 2; *Nielson v. Johnson*, 279 U.S. 47 (1929); *United States v. Belmont*, 301 U.S. 324, 331 (1937).

EMI Limited, as a foreign juridical national, is entitled to the benefits of international law, and the restrictions international law imposes on governments that would tax it.

2. The Confederation could not govern effectively because the Articles left the states free to tax and impede foreign commerce, to have foreign relations and even to make treaties. The Constitution was intended to remove all of these powers from the states. There was less concern with burdens on interstate commerce. The Constitution should be construed to forbid all state burdens on foreign commerce and not merely those similar to prohibited burdens on interstate commerce. *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) correctly perceived the distinction.

3. While international law does not restrict California's right to tax the Container Corporation on its income derived from business done within the United States, it may restrict California's right to tax Container Corporation on its income realized from business done in Colombia, Venezuela and other foreign countries. Compare *Sumitomo Shoji America, Inc. v. Avagliano,* No. 80-2070 and 81-24, October Term, 1981, decided June 15, 1982.

However, the Court need not reach consideration of that possibility. International law condemns use of the combined unitary formula because it burdens the commerce their juridical nationals conduct with the United States. This is foreign commerce. The unitary tax is just as burdensome when it is applied to domestic multinational groups. What the states may not burden is the foreign commerce of the United States, regardless of who conducts it.

Furthermore, to permit a tax on one group of multinationals which international law prohibits on another is a burden on the foreign commerce of one which the other escapes, a classic discrimination. Discrimination between competitors in foreign commerce is itself a burden, and is impermissible.

ARGUMENT

INTRODUCTORY

There are two aspects to the problem the court is faced with in the Container Corporation case: International Law; and the foreign commerce clause (Article I, Section 8, cl. 3). Both, under the United States Constitution, are limitations on the powers of the states to tax. They are not necessarily synonymous limitations, however.

Restrictions may be found on the powers of the states to tax because of the compulsion of the Commerce Clause, and not because any restriction is found in established international law. The decision of this Court in *Japan Line Ltd. v. County of Los Angeles,* 441 U.S. 434 (1978), is an

example. However, in this case there are considerations of international law which the Court should take into account.[1]

I. The use of the arm's length method of determining the income which a Nation has authority to permit its subdivisions to tax, and the avoidance of double taxation through credits, have both become principles of international law, precluding the use by the states of combined apportionment formulae against those corporations entitled to rely on international law

A. EMI Limited, a corporation of the United Kingdom, and its American subsidiary, Capitol Industries-EMI Inc., both have standing to complain of a violation of international law by the state of California and any other states of the union. International law generally deals with the power of a state to enact tax legislation and other legislation exemplifying its power on nationals, whether individual or juridical, of other states.[2] Thus it is a recognized principle of international law that the United States could not tax EMI Limited on any portion of its income, because EMI Limited does not do any business in the United States, and has neither office nor permanent establishment here. Restatement (Revised), Sec. 412(1)(c) and comment (a). Its ownership of a subsidiary is, under international law, the recognized form for it to operate in the United States, and the law of the United States applies fully to that sub-

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[1] In *Japan Line*, supra, this Court relied on international custom to establish a standard by which the states are bound, not as a matter of international law, but under the commerce clause. As we will show, international custom becomes the law of Nations, by which the states are also bound.

[2] The custom in international law and communications between governments is to refer to Nations as states. In discussing international law within the United States, the political subdivisions of the United States comprising the United States are referred to as States of the Union. To avoid the use of the same word with different meanings in different sections of this brief, we shall hereinafter refer to the Nations of the world as Nations, and to States of the Union as states.

sidiary, but without disregard of corporate entity. *Sumitomo Shoji America, Inc. v. Avagliano,* decided June 15, 1982, Nos. 80-2070 and 81-24, Oct. Term, 1981. Restatement of Foreign Relations Law, Second, Sec. 27, Sec. 172; Restatement (Revised) (1982) Sec. 216, Sec. 418, comment (b).[3] However, the United States is not so limited in taxing Container Corporation, since that corporation is a national of the United States. Restatement (Second), Sec. 27; Restatement (Revised) Sec. 418. Nevertheless, in taxing Container Corporation, the United States is bound to give effect to Venezuelan law where it places limitations on the Venezuelan subsidiary, since the Venezuelan subsidiary is a national of another nation. Cf. *Sumitomo Shoji America, Inc. v. Avagliano, supra.* Restatement (Second), Sec. 30, comment (b); Restatement (Revised) Sec. 418(4). Venezuela is but one example, typical, perhaps, of each of the nations in which Container Corporation has subsidiaries operating which are incorporated under the laws of that host country. It is not our purpose to demonstrate that there are such foreign restrictions, but to suggest that they may exist, and that possibility is a consideration always to be kept visible in the background in analysis of the international law aspects of this entire issue. It is obviously most clearly evident, and is a foreground consideration, in analyzing the tax status of foreign parent corporations, such as EMI Limited, operating in the United States only through a separately incorporated subsidiary, and bound by the Official Secrets Act of the United Kingdom not to reveal to any foreign government any financial or other information about its activities as a defense contractor for the United Kingdom forces.

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[3]Hereafter the Restatement of the Foreign Relations Law of the United States, Second (1965) will be cited simply as Restatement (Second). The Draft Restatement of the Foreign Relations Law of the United States (Revised), still in process with three volumes published but not finally approved, will be cited as Restatement (Revised).

International law is found in treaties, but not exclusively there. It is also found in enactments of the United Nations, in the statutes creating and the decisions of numerous international courts, such as the International Court of Justice and the World Court, and, most importantly, in custom. Restatement (Second), Sec. 1, Comment C; Restatement (Revised) Sec. 102; Article 38(1), Statute of the International Court of Justice;[4] Statute of the World Court, Art. 36, to which the United States acceded in 1926.

This Court has recognized that internationally accepted custom is international law. As such, it has been given effect by this Court, binding nationals of the United States, and governing this Court in its decisions. *The Paquete Habana*, 175 U.S. 677 (1900), *Sears v. The Scotia*, 81 U.S. (14 Wall) 170 (1872). The first cited case dealt with the principle recognized by international custom that fishing vessels were not subject to capture as prizes of war. No treaties to which the United States was a party so provided, or dealt with the subject. The Court said, however,:

> "By an ancient usage among civilized nations, beginning centuries ago, and gradually ripening into a rule of international law, coast fishing vessels, pursuing their vocation of catching and bringing in fresh fish, have been recognized as exempt, with their cargos and crews, from capture as prize of war." (175 U.S. at 686).

The Paquete Habana was therefore held not subject to capture as a prize of war, because of the restrictions of international law.

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[4]Article 38(1) reads as follows: The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply: (a) international conventions, whether general or particular, establishing rules expressly recognized by the contesting states; (b) international custom, as evidence of a general practice accepted as law; (c) the general principles of law recognized by civilized nations; and (d) . . . judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

The *Scotia*, supra, was also an example of custom governing the rules of the sea, not found in any treaties, but which had evolved into a principle of international law. The case arose in the 19th century, when steamships were plying the same seas as sailing vessels but had not supplanted them. Because of the superior maneuverability of steamships, the custom had evolved that they must give way to sailing vessels to avoid collision. After surveying the regulations which had been evolved by thirty countries, but without treaties governing the subject, this Court concluded that that was sufficient custom to become a basis of international law. The Court held, accordingly, that the decision in the case was governed by that custom, as one of international law which the courts of the United States must apply. To borrow language this Court later used:

> "International law . . . has at times, like the common law . . . , a twilight existence (while) the gradual consolidation of opinion and habits . . . has been doing its quiet work." (*New Jersey v. Delaware*, 291 U.S. 361, 383-384 (1934)).

The recognition of custom as international law, while an old principle, is still respected, and still represents internationally recognized international law. Restatement (Second), Sec. 1, comment c; Restatement (Revised) Sec. 102; Statute of the International Court of Justice, Sec. 38(1) (supra footnote 4 p 7); *McCulloch v. Marineros de Honduras*, 372 U.S. 10, 21 (1963).

In the present case, we have an evolved international custom, respected by nations of the world, and particularly the treaty nations since they have bound themselves by bilateral treaties to enforce common standards about the source of taxable net income and the prevention of double taxation. This Court has been informed by the official representative before it of the Executive of the United States government that it is the view of that government that there is an international custom, embodied in many treaties but also in international practice where

treaties are not in force, limiting jurisdiction to tax to the income earned within its borders, and to the determination of that income by the armslength fair price method, to avoid double taxation. See also Restatement (Revised), Sections 411, 412(1)(c) and 413. The Reporter's Comment, set forth in Appendix A hereto, discusses the subject in a manner which we believe has not before been called to the Court's attention. It is to the same effect as what the Court has learned from other sources, however.

In addition, as this Court has been informed repeatedly, the government of the United Kingdom for itself, and also both it and the government of Italy, in each instance acting as president of the Commission of the European Economic Community, for that community of ten nations, have filed diplomatic representations with the Department of State stating that there is an internationally recognized standard and protesting the departure from it by California and other states which have been most prominent in ignoring that international standard.

The Executive has informed both this Court and the Congress that the consolidated unitary formula applied by those states conflicts with internationally recognized practice established by treaty and custom. Judicial recognition should be given to that fact, and the necessary corollary that it is prohibited by international law, where the economic effect of the tax would fall on a national, individual or juridical, of another nation. Thus Secretary Blumenthal, Assistant Secretary Laurence Woodworth, Assistant Secretary Donald Lubick, and now the Solicitor General have stated that the Executive recognizes that international practice, and have stated that the states should be bound by it in their own taxing policies. Moreover, testimony before the Senate Foreign Relations Committee in 1977 was to the effect that the previous administration (before the Carter administration) had also recognized that principle and in deference to it had acceded to the British request that an explicit prohibition of violation of the principle by a state

should be placed in the United States-United Kingdom Income Tax Convention then being negotiated. (See Appendix B for statement of former Assistant Secretary of the Treasury, Charles Walker.)

This Court has held repeatedly that in foreign relations the United States must speak with a single voice and has stated also that ordinarily that voice is that of the Executive. (*Baker v. Carr*, 369 U.S. 186, 211 (1972); *Japan Line Ltd. v. Los Angeles County*, 441 U.S. at 449; *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976); *United States v. Belmont*, 301 U.S. 324 (1937); *Chy Lung v. Freeman*, 92 U.S. 275, 279 (1876)). The governing principle has perhaps never been stated more eloquently then by this Court in *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 319 (1937):

> "Not only, as we have shown, is the Federal power over external affairs in origin and essential character different from that over internal affairs, but participation in the exercise of the power is significantly limited. In this vast external realm, with its important, complicated, delicate and manifold problems, the President alone has the power to speak or listen as a representative of the nation. He makes *treaties* with the advice and consent of the Senate; but he alone negotiates. Into the field of negotiation the Senate can not intrude; and Congress itself is powerless to invade it. As Marshal said in his great argument of March 7, 1800, in the House of Representatives, 'The President is the sole organ of the nation in its external affairs, and its sole representative with foreign nations.'"

Thereafter the Court characterized the Presidential power in the following terms: (299 U.S. at 320):

> ". . . the very delicate, plenary and exclusive power of the President as the sole organ of the Federal government in the field of international relations—a power that does not require as a basis for its exercise an act of Congress. . . ."

Later, in *United States v. Shaughnessy*, 338 U.S. 537, 542-543 (1950), this Court stated that the admission of aliens into the United States was solely within the prerogative of the President to govern, and he could do it with or without specific act of Congress. The language this Court used was:

> "The exclusion of aliens is a fundamental act of sovereignty. The right to do so stems not alone from legislative power but is inherent in the executive power to control the foreign affairs of the nation. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304; *Fong Yue Ting v. United States*, 149 U.S. 698. When Congress prescribes a procedure concerning the admissibility of aliens, it is not dealing alone with the legislative power. It is implementing an inherent executive power."

In an ensuing paragraph the court again said that "the power of exclusion of aliens is also inherent in the executive department of the sovereign, . . ."

Later cases recognize this principle. Thus in *Baker v. Carr*, 369 U.S. 186 (1972), this Court analyzed the effect of determinations by the other branches of government in the field of foreign affairs, and stated that (369 U.S. 186, at 212) "the judiciary ordinarily follows the executive . . ." in such matters.

Finally, and most recently, in *Dames & Moore v. Regan*, ... U.S. ....., 69 L.Ed 2nd 918 (1981) this Court upheld the validity of the provision in the Executive Agreement by which the American hostages were returned by Iran, which removed settlement of American claims against Iranian assets from the courts, where litigation to enforce them was pending, and vested it exclusively in an agency created by the joint agreement of the executives of the two affected countries. The Court examined legislation Congress had adopted and concluded that it neither authorized nor forbade what the Executive Agreement had done, and hence the authority for the agreement must be found in the

Executive's power. The Court upheld the Executive Agreement, even though the effect was to remove jurisdiction from the courts in litigation already pending.

The principle is so well established that it is stated in the Restatement (Revised) Section 132, and comment c. to that section. The words of the comment are these:

> "Courts give particular weight to the position taken by the United States government because it is desirable that so far as possible the United States speak with one voice on such matters. Compare *Baker v. Carr,* 369 U.S. 186, 217 (1972), quoted in Introductory Note to Scope, P4. The views of the United States government, moreover, are also state practice, creating or modifying international law. See Section 102 and Comment b. Even views expressed by the Executive Branch as a party before the court or as *amicus curiae* will be given substantial respect since the Executive Branch will have to answer to a foreign state for any alleged violation of international law resulting from the action of a court."

As we have shown, international law arises from internationally accepted custom, and this need not be in writing. Section 102, Restatement (Revised) states that international law is that which has been accepted as such by the international political system (a) in the form of customary laws; (b) by international agreements; or (c) by derivation from general principles of law common to the major legal systems of the world. The Statute of the International Court of Justice, Sec. 38(1), expressly states that international custom becomes international law. (Footnote 4, supra p. 7)

Customary international law results from a general and consistent practice of Nations followed by them from a sense of legal obligation. Even between the United States and non-treaty nations such as Venezuela and Colombia the tax principles found in the treaties are applied. See Restatement (Revised) Sections 411, 412(1)(c) and 413. This

adherence by non-treaty nations to the tax principles in treaties is an example of this growth of international law.

We have seen that the treaty nations and the United States have agreed that double taxation will be avoided, and that the method by which it will be avoided is to use the armslength fair price method in testing whether international commercial transactions between commonly owned corporations are at unrealistic prices having the effect of distorting the source of taxable income, and providing for the reconstruction of the proper taxable income by the fair price method. As this Court recognized in *Japan Line*, neither by treaty nor custom have nations agreed to avoid double taxation by using a common apportionment formula, and they have not agreed to either a method or tribunal for settling disagreements about the operation of the formula. They have agreed instead, by treaty where such treaties exist and by custom where they do not, to tax only the income earned within their borders and to ascertain it by the fair price armslength method. This is recognized as international law. Restatement (Revised), Section 411 and 412 and Reporters' Notes, comment 3. The Restatement (Revised) also declares that the United States' view of international law is that it requires either the exemption of income a nation could tax or a credit for taxes paid elsewhere to avoid double taxation. Section 413. Every state using the combined formula violates this rule, because not one of them allows a credit for foreign taxes, or even a deduction.

The formula has no interest in the armslength method. Instead it makes a conclusive assumption that all world business is conducted in the same manner, at the same mark-ups, at the same labor costs, and the products are sold at the same prices to customers, wherever manufactured, and wherever sold. The Court has been told repeatedly in briefs of the parties and of other amici curiae that statistics and other sources of judicial notice demonstrate that those assumptions are contrary to the fact, and indeed

we suspect that the Court has sufficient economic sophistication to know without prompting that those assumptions are economic nonsense. So we see the American states attempting to use a standard which international practice disavows, between both treaty nations and non-treaty nations. The fair price method is respected in tax practice between the United States government and the government of such nations as Venezuela, Colombia, Peru, Chile, and other countries with whom the United States does not have bilateral income tax treaties. Section 482 of the Internal Revenue Code of the United States does not distinguish between treaty nations and non-treaty nations, and Treasury practice as well as international practice is to make no such distinction, either. The fair price method is used between all nations, including those in which Container Corporation has foreign subsidiaries.

The states of the union are, of course, bound by international law. The Constitution explicitly provides so (Article VI, Section 2; Article I, Section 8, cl. 10), and this Court has often so held. *Nielsen v. Johnson,* 279 U.S. 47, (1929); *Kolovrat v. Oregon,* 366 U.S. 187 (1961); *United States v. Belmont,* 301 U.S. 324 (1937). The first case involved the binding effect of a treaty on state taxation. The court has not distinguished between treaties and other sources of international law and has held the states bound by international law from whatever source derived. *Banco Nacional De Cuba v. Sabbatino,* 376 U.S. 398, 425 (1964); and see also Restatement (Revised) Section 135(1).

We believe the foregoing discussion demonstrates that the question of the application by the states of the United States of a combined unitary formula to reach the income of foreign parent corporations which operate in the United States only through American subsidiaries is a question of international law, not of state law or even exclusively of United States constitutional law, and that international law has evolved from the settled international practice of using the armslength method between nations. When the official

representative of the Executive in this Court, the Solicitor General, at the request of the Secretaries of State, Treasury and Commerce, and the United States Trade Representative, acting in response to the urging of a majority of our leading foreign trading partners through their official channels, appears in this Court and informs this Court that the Executive Branch recognizes the existence of a settled practice of nations, this Court will, under its settled precedents, recognize that the Solicitor General has spoken as the Executive, and that his statement of views is that of the single voice by which the United States speaks in foreign affairs. It is a declaration to this Court that the United States Government recognizes this "settled" practice as international custom. International custom is international law.

In the conduct of relations between nations, the Executive's recognition of a certain rule as international law is not subject to reconsideration by the other branches of government, or by the states. The states must conform their taxing principles to the fair price armslength method. When the Executive informs this Court that is the sole standard permitted by the international law this Government recognizes, then it follows that any other method, including the combined unitary formula, is unconstitutional because it is contrary to international law.

The foregoing analysis of the views of the Executive communicated through the Solicitor General is a proper distillation of what this Court has held in the past. The "sole voice," "sole organ" statements found repeatedly in this Court's opinions necessarily represent a recognition that some one branch of government possesses that voice. Also, the doctrine means that that voice cannot be drowned out by another governmental voice, state or federal.

This Court's decisions, not only its words, recognize the point. Thus the delegation of powers rule is not offended by an indistinct statute delegating to the President the power to restrict immigration of aliens, for he has the

power without the legislation. *United States v. Shaughnessy,* 338 U.S. 537; *Fong Yue Ting v. United States,* 149 U.S. 698 (1893). Similarly, the breadth of the delegation to the President of authority to grant or deny licenses to operate commercial airplanes in foreign commerce did not present a delegation problem because of the President's inherent powers. *Chicago & Air Lines v. Waterman S.S. Corp.,* 333 U.S. 103 (1948). Also, the same case held that the President need give no reason for his exercise of that power because it is not subject to judicial review. *Id.* Perhaps of even greater significance is the fact that the landmark case *United States v. Curtiss-Wright Export Corp.,* 299 U.S. 311 (1936), also involved an issue of overbroad delegation of power to the President in the field of foreign affairs, and the Court held that the President's power to act alone in that field was so great that there could be little room in that area for the unlawful delegation concept. The force of the emphasis on the vast scope of Presidential power to act alone if need be in foreign affairs is greatly increased by the fact that in the previous year the Court had invalidated a delegation of authority to the President as overly broad where it dealt with domestic affairs. *Schechter v. United States,* 295 U.S. 495 (1935). Hence the Court had to be very serious when it said (299 U.S. at 319):

> "In this vast external realm, with its important, complicated, delicate and manifold problems, the President alone has the power to speak or listen as a representative of the nation."

Quite recently this Court has had two occasions to consider the Executive power in foreign relations, first in *Haig v. Agee,* ..... U.S. ....., 69 L.Ed. 2d 640 (1981), and three days later in *Dames & Moore v. Regan,* ..... U.S. ....., 69 L.Ed. 2d 918 (1981). We have already analyzed *Dames & Moore,* supra p. 11. *Haig v. Agee* upheld the power of the Executive to cancel the passport of a United States citizen residing abroad, although the statute in question did not explicitly confer the power. The Court noted that neither

did the statute deny the power, and pointed out that the President had issued and denied passports under his prerogative before 1856, when the first statute on the subject was passed. The Court observed that that confirmation of presidential power occurred in order to vest it in him solely and deny it to the states (69 L.Ed. 2d at 654, footnote 27). The Court also spoke of the weight of administrative construction (69 L.Ed. 2d at 652):

> "This is especially so in the areas of foreign policy and national security, where congressional silence is not to be equated with congressional disapproval."

So here, the absence of enabling legislation does not imply either Congressional disapproval or an absence of Presidential power. Quite the contrary, for if there is not Presidential power then there is a vacuum in which the United States has no voice in its own foreign affairs, a situation not to be countenanced. *United States v. Curtiss-Wright Export Corp.*, supra, 299 U.S. at pp. 317-318.

Previous Executive agreements were reviewed in the opinion. Among the most famous is the Litvinov Agreement ancillary to the Executive's decision to recognize the Soviet regime as a legitimate government. In *United States v. Pink*, 315 U.S. 203 (1942), the Court upheld the power of the Executive to enter into the Agreement even though one aspect of it was to overrule a property decision of the New York Court of Appeals. Previously it had held that agreement superior to the public policy of New York, which did not recognize the validity of uncompensated expropriations. *United States v. Belmont*, 301 U.S. 324 (1937).

Since the power of the Executive to act alone in representing the interests of this nation in foreign affairs is so firmly established, there remains only the question whether the power to determine that an international usage or practice has become so firmly and generally recognized by Nations as to have become international law rests in the Executive. We submit that to be effective it can repose in

no other branch. It cannot repose in the judiciary, for the judiciary cannot give advisory opinions, and the main thrust of any recognition of a commonly accepted international usage as international law is present and prospective. It means our nation does and will respect it in votes at the United Nations and its agencies, on the high seas, and in the countless forces agreements this nation has with the nations where we have bases. There are, obviously, other examples as well. The Supreme Court fully stated its own views of the reasons the judiciary cannot share in the power to conduct foreign relations in these words (*Chicago & S. Air Lines v. Waterman SS Corp.*, supra, 333 U.S. at 111):

> "The President, both as Commander-in-Chief and as the Nation's organ for foreign affairs, has available intelligence services whose reports are not and ought not to be published to the world. It would be intolerable that courts, without the relevant information, should review and perhaps nullify actions of the Executive taken on information properly held secret. Nor can courts sit in camera in order to be taken into executive confidences. But even if courts could require full disclosure, the very nature of executive decisions as to foreign policy is political, not judicial. Such decisions are wholly confided by our Constitution to the political departments of the government, Executive and Legislative. They are delicate, complex, and involve large elements of prophecy. They are and should be undertaken only by those directly responsible to the people whose welfare they advance or imperil. *They are decisions of a kind for which the Judiciary has neither aptitude, facilities nor responsibility and which has long been held to belong in the domain of political power not subject to judicial intrusion or inquiry.*" (Emphasis ours.)

The "political power" the Court referred to was that of the Executive. Neither can the power to recognize inter-

national law require congressional approval in order to exist, although it surely can be regulated by Congress to some extent, because the proper exercise of the power requires facilities Congress does not possess. Our embassies and consulates abroad are of the Executive Branch and are, as this Court has said, the President's eyes and ears abroad. It is to the Department of State that representations are made by other nations that certain conduct has been so universally rejected as proper conduct by nations that its prohibition is a mandate of international law. Those nations must negotiate that recognition with the President, not the Congress.

Approached differently, Congress does not conduct the foreign affairs of the United States. The President does that, for he "alone has the power to speak or listen as a representative of the nation." *United States v. Curtiss-Wright Export Corp.*, supra, 299 U.S. at 319. As an aspect of foreign affairs, the determination of what international customs and practices are to be recognized by this Nation as binding on it under international law is in the President.

These views, we believe, will govern this Court when it considers the status of a foreign corporation such as EMI Limited. We recognize that the power of the United States and hence presumably of its political subdivisions to tax American corporations is not governed by international law, but derives exclusively from the Constitution, and the domestic legislative powers it recognizes. Yet international law may govern the extent to which the United States and its political subdivisions may reach out to foreign countries and assert the power to inquire into transactions conducted in those foreign countries by subsidiaries formed in those countries but owned by American parent corporations, and also to tax income derived from those transactions. Thus a foreign nation, such as Colombia, might find that the economic effect of the use by the States of the combined unitary formula could be to com-

pel the American parent corporation to withdraw more income from Colombia's subsidiary than Colombia felt compatible with its foreign exchange laws, because of the impact of such payments on Colombia's balance of payments in respect of the United States, and such incompatibility would be a matter of concern under international law, and could prohibit the state's formula being applied. See *Sumitomo Shoji America, Inc. v. Avagliano,* supra. Certainly, it could be anticipated that any foreign country would both resent and resist any effort by a state to send a tax auditor into that foreign country for the purposes of verification of information supplied by the parent corporation to the taxing state.

B. Another aspect of international law which the states' combined unitary formulae violate is the recognition in international law that deductions or credits for foreign taxes on the same income should be allowed, since there should not be double taxation of the same income. See Section 413, Restatement (Revised).

Since 1919, the United States revenue laws have permitted the foreign income taxes to be a credit against the United States income tax, where a credit is not allowed in reverse, to avoid double taxation. This provision appeared in the 1919 act as Sections 222 and 238, and will now be found in Section 901 of the Internal Revenue Code. The United States is a party to 40 bilateral income tax conventions, a few of which have not yet been ratified, and all of them provide for the allowance of credits, either by the United States or by the foreign government, depending upon which is the country of domicile and which is the country where the income has been earned. The model draft of the Income Tax Convention published by the League of Nations and by the Organization for Economic Cooperation and Development so provide also, as do the London and the Mexico Model Tax Conventions. The Organization for Economic Development taxation convention, in Articles 23(a) and 23(b), prohibits double tax-

ation and provides for credits. Finally, The United Nations Model Double Taxation Convention between Developed and Developing Countries, United Nations Document ST./ESA/102, likewise contains provision for such credits.

It is apparent that the avoidance of double taxation has become an internationally recognized objective, found in all bilateral income tax treaties to which the United States is a party, in such treaties between other countries, and in the model conventions of the United Nations and other international organizations. In such circumstances, with such virtual unanimity between Nations, the practice of the United States in these treaties is a recognition of the existence of an international standard which has become international law. It is custom which has become universal, and as such is international law. The states should be held bound by this international law, and their uniform failure to allow either a deduction or a credit for the foreign income which they reach out to tax by the formula is unconstitutional as in violation of international law.

C. These views are essentially similar to those this Court expressed in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 424 (1979), except that there the invalidated apportionment did not involve a type of tax which had produced a network of bilateral treaties and a series of model treaties proposed by the United States, the United Nations and others. The evidence of custom ripening into international law was less compelling there than here, but the result the Court reached was precisely the same as it would have reached had it treated the custom as international law instead of an international policy the foreign commerce clause respected.

II. The history of the failure of the Confederacy and the substitution of the Constitution shows that the tolerance of some state burdens on interstate commerce does not extend to burdens on foreign commerce

The failure of the Articles of Confederation to provide a workable Union, and the impetus behind the substitution

of the Constitution for the Articles, were primarily because the Articles left each State free to tax and impede foreign commerce, and to have its own foreign policy.[5] The Framers of the Constitution were determined to correct those weaknesses and deprive the states of all jurisdiction over foreign commerce and foreign policy.[6] The last holdouts in the ratification process realized this and their reluctance to surrender the commercial advantage of their seaboard location was because of their knowledge.[7] Unless the lessons of history are lost on us today, the states must be denied their effort in this case to reclaim some of that surrendered power.

By applying its apportionment formula to foreign source income regardless of whether derived from discrete foreign businesses, and regardless of whether foreign income from foreign commerce can be determined by the arms length methods Nations use to determine what they can tax, California is doing what the Framers of the Constitution resolved no state could ever again do; have independent foreign relations and burden the Nation's foreign commerce by repressive taxation.[8]

The failure of the Confederation so soon after the Treaty of Independence, due to the emergence of commercial rivalries between the states, each of which was free to have and pursue its own foreign policy, make treaties, and burden the foreign commerce of its neighbors, led the Framers of

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[5]*Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283 (1976); I Curtis, History of the Constitution of the United States (1854, Harper and Brothers, N.Y.) 148, 179-180, 276; II Curtis, op. cit., pp. 11-14, 289-298; 3 Farrand, The Records of the Federal Convention of 1787 (1911), Appendix A, CCCCI, 539, 547-548.

[6]II Curtis, op. cit., pp. 11-12, 13-14, footnotes; The Federalist XLIV (Jay); The Federalist XI (Madison).

[7]II Curtis, op. cit., pp. 23-24.

[8]II Curtis, op. cit., pp. 289-298; James Madison, Preface to Debates in the Convention of 1787, set forth in 3 Farrand, op. cit., Appendix CCCCI, 539, 547-548.

the Constitution to agree that those practices must be prohibited. There was debate over whether the states should remain free to regulate trade between themselves but none over the termination of their freedom over foreign commerce. Therefore the Constitution removes from the states any power over foreign relations and over foreign commerce. Any state regulation of foreign commerce is a burden the Framers meant to prohibit.

Against this historical background, the distinction this Court drew between foreign commerce and interstate commerce in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), is not only sound, but an inevitable lesson of history. Some state burdens on interstate commerce may be tolerated by the silence of Congress to prohibit them, but not on foreign commerce. Only the Federal government can regulate that.

III. State taxation of domestic multinational groups by a method more onerous than the method international law requires be used in taxing foreign multinational groups is a burden on foreign commerce

The practices which are violations of international law when applied against corporations which are nationals of foreign countries are unconstitutional burdens on foreign commerce when applied to corporations which are nationals of the United States. Because they are burdens is why international law prohibits them. The Executive, through his representative before this Court, the Solicitor General, has informed the Court that the operation of the states' combined unitary apportionment formula has become a burden on foreign commerce. In his brief he has stated that the clearest and most obvious burden is felt when the states attempt to impose that taxing method on a multinational group with a foreign parent, but he has also stated that the burden also exists when they attempt to apply it to domestic corporations with foreign subsidiaries conducting their business in other countries, which are themselves sovereign countries.

This Court stated its recognition of the ability of the Executive to sense the effect of intrusions by other forces into the conduct of our external affairs, in a case previously cited, *United States v. Curtiss-Wright Export Corp.*, supra. We quoted above some of the Court's language in that opinion, and we again quote the most essential and significant statement of awareness of the subtlety of manifestations of foreign impact:

> "In this vast external realm, with its important, complicated, delicate and manifold problems, the President alone has the power to speak or listen as a representative of the Nation." 299 U.S. at 319.

From what this Court has recognized is a superior listening post, the Executive has discerned a burden on the foreign commerce of this nation, which is one manifestation of its external affairs, and that it burdens the foreign commerce of this nation whether it is conducted by foreign corporations or by domestic corporations, through foreign subsidiaries.

The use by American parent corporations of subsidiaries incorporated under the laws of the foreign countries is mandatory as a practical matter. These foreign countries are themselves sovereign, and hence they have the sovereign's authority to pass laws, create conditions for operation of businesses, and conditions for shipment of profits done from business within their borders to the American parent. To avoid a conflict between requirements of United States and those of the host country, therefore, it is essential that a foreign subsidiary, fully amenable to the laws of the host country, be established. This is particularly vital in those countries, such as Mexico, which require some equity participation by their own nationals in foreign controlled operations in their country. Not only are these foreign subsidiaries convenient, but it is apparent that they are in most instances practical necessities. For the states to disregard their existence and treat the operations abroad as being conducted by the American parent, and as

being conducted, contrary to notorious fact, in an economic climate parallel to that in the United States as to price levels, wage levels, margins of profit, and other essentials of economic success in commercial transactions, impresses us as being a burden on foreign commerce by definition. But the Executive, who has commercial attaches in embassies, consular offices whose function in part is to assist American business abroad, and an entire department devoted to foreign commerce, whose head (the Secretary of Commerce) has protested to the Solicitor General that what the states are doing is a burden on foreign commerce which should be stopped, has declared that it is. The evidence which this Court spoke of in *Japan Lines* is even more abundantly present here.

Finally, in this aspect of the discussion, the Court spoke in *Japan Lines* of the danger of retaliation if a formula suitable for taxation in internal commerce were applied to foreign commerce, since the foreign countries could not be compelled to surrender taxing jurisdiction to the American states. That retaliation has occurred and is present for this Court to consider, in viewing the available evidence of the effect on foreign commerce of the states' combined unitary formula. The Court has been told of the British retaliation for the action of a Senate minority in blocking approval of the explicit prohibition in the new treaty of what the states are doing here, insofar as British parent corporations and their domestic subsidiaries are concerned. The treaty had to be returned to the United Kingdom for reenactment by the Parliament. The testimony of Assistant Secretary of the Treasury Lubick, and particularly the letter which he wrote to the Senate Foreign Relations Committee members when the new provision the British insisted be added to the treaty was before the Senate for ratification, show that the new provision was placed in the treaty by the British in retaliation for the removal of Article 9(4). Secretary Lubick explained the adverse impact of the new provision on American business, and its benefits to the United King-

dom. A price was exacted for the blocking of approval of Article 9(4) by a minority of the Senate. This is the first retaliation, apparently, but more is to be expected if this state taxing method is approved by this Court, in view of the volume of protests which have been voiced to this government by the members of the Common Market, by the Canadian government and now also by Japan. We urge that this irritant be removed by this Court before its adverse impact on our relations with other foreign countries becomes similarly evident and outspoken.

While international law, which prohibits the states' applying their combined unitary formula to a corporate group headed by a foreign parent corporation and thereby to reach for taxation some of the income of that foreign parent, does not restrict the states in the same way when attempting to tax a United States parent corporation with foreign subsidiaries by the same combined unitary method, a related principle may do so. Regulations within the states' traditional areas of jurisdiction will fall, absent a treaty or the compulsion of international law, "if they impair the effective exercise of the Nation's foreign policy." *Zschernig v. Miller,* 389 U.S. 429, 440 (1968). This Nation's foreign policy is to refrain from double taxation of international income. Compare *McCulloch v. Marineros de Honduras,* supra, 372 U.S. 10, where a neutral federal statute was construed not to apply to foreign merchant seaman in order to avoid embarrassment to our foreign relations.

However, we submit that there is a direct constitutional bar here, because the states' formula is a burden on foreign commerce, prohibited by the United States Constitution. If international law prohibits the states' applying their combined unitary formulae to multinational groups headed by a foreign parent corporation, as we contend, and if there is not a corresponding prohibition against the states applying that formula to multinational groups headed by American corporations, a discrimination between foreign groups and domestic groups is established. If this results in a

heavier state tax burden for the domestically-owned multinational groups than for the foreign-owned groups, that discrimination impairs their competitive position and itself becomes a burden on foreign commerce. We do not believe it reasonable to consider that the foreign commerce clause can permit the states to discriminate against American owned multinational groups. If they are not permitted to compete on equal terms with their foreign opposite numbers, then they are burdened in the conduct of their foreign commerce. Inequality of treatment when translated into economic consequences is itself a burden on foreign commerce and as such is unconstitutional.

This Court has long and consistently held that a state tax system which discriminates against commerce is a prohibited burden on it. *Maryland v. Louisiana,* 451 U.S. 725 (1981). A tax system which burdens some foreign commerce but not all discriminates against some foreign commerce and burdens it. This the states cannot do.[9] The discrimination cannot be overcome by extending the scope of the unitary formula to tax the foreign-earned income of foreign multinational groups, so it must be overcome in the only way in which it can be: by restricting the power of the states to burden the foreign source income of domestic multinationals. Essentially that technique was used in *Japan Line Ltd. v. Los Angeles County,* supra, 441 U.S. 434, where the property was physically within the taxing county but jurisdiction to tax was denied because the home country had jurisdiction to tax which the United States could not control.

Furthermore, consideration of the reason behind the international custom which has evolved into international law shows that it evolved in order to avoid unacceptable burdens on the commerce the nations of the world conduct

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[9]*Matson Navigation Co. v. State Board,* 297 U.S. 441, (1936), construed the Equal Protection Clause, not the Foreign Commerce Clause and did not involve income earned and taxed abroad.

with each other. The rules evolved to remove burdensome taxation of income earned in another country, and to prevent double taxation, and they accomplish this in part by acknowledging the prior claims to taxation in the country where the business is done over the claims of the home country, producing a custom in which the latter defers to the former in allowing credits for taxes paid. The states offend the foreign commerce clause in two ways: they impose the burdensome double tax, and they make no effort to ameliorate it through a credit, or even a deduction. The burden they impose on the foreign commerce of domestic internationals, accordingly, is greater than that which the international community finds acceptable when dealing with the juridical nationals of other countries.

The dimensions of this burden on foreign commerce are seen from the record in the Container Corporation case. According to the computations found in Container Corporation's amicus brief filed in the Chicago Bridge & Iron case (No. 81-349, Oct. Term 1981), Container's California income is more than doubled by the combined unitary formula, and the cause is not business done between California and Venezuela, for example, for there is none, but is the minutiae the state courts have declared represent unitary characteristics. Such an increase in income cannot possibly come from that minutiae, as this Court held on June 29, 1982 in *Asarco, Inc. v. Idaho Tax Commission,* No. 80-2015, and *F. W. Woolworth Co. v. Taxation and Revenue Department,* No. 80-17745. The Court may readily conclude that Container Corporation is not unitary with its foreign subsidiaries under the standards stated in those cases, but we hope the Court will also deal with the broader aspects of the case, and state its agreement that international law, the single voice doctrine, and the foreign commerce clause all prohibit the extension of the combined unitary formula system to income earned from operations in other countries.

We conclude our argument by acknowledging that there is language in the opinion in *Mobil Oil Corp. v. Comm. of*

Taxes, 445 U.S. 425 (1980) which, when removed from the context of the issue framed in that case, could suggest that the Court has already prejudged the suitability of a formula to allocate foreign source income. We believe the Court does not decide issues which the parties before it concede, and that it was merely acknowledging Mobil's concession that in its case the formula used could be applied to its business income (445 U.S. at 434). The Court said (445 U.S. at 437) "Indeed, in its Vermont tax returns, Mobil included all its operating income in apportionable net income, without regard to the locality in which it was earned." As the *Caterpillar* case (No. 81-349, Oct. Term, 1981) demonstrates, a formula sometimes operates to a taxpayer's advantage. Moreover, the Court said that Mobil had failed to introduce any evidence that its foreign operations were "distinct in any business or economic sense from its petroleum sales activities in Vermont." 445 U.S. at 439. Finally, in both *Exxon Corp. v. Wisconsin Dept. of Revenue,* 447 U.S. 207, 223 (1980), and in *Asarco, Inc. v. Idaho State Tax Commission,* supra, slip opinion, p. 11, this Court referred to the now famous "linchpin" statement in *Mobil* as referring to "state income taxation of an *interstate* enterprise" (Emphasis ours). We conclude the foreign commerce issues remain open issues.

The Court may ponder why a United Kingdom parent corporation and its American subsidiary should be concerned by the plight of their American owned competitors. The answer is that the combined unitary formula is a festering sore in the international commercial world, which breeds distrust and antagonism which are of no benefit to anyone in foreign commerce, and undoubtedly will produce further international reaction. Immunity in some but not in all would simply increase antagonisms. International commercial relationships are conducted most effectively when the competition between those manufacturing and selling goods in international commerce is on the basis of quality, price, service, and other commercial considera-

tions, and not when one group of competitors is burdened by an aberrant tax burden from which the other competitors are free.

Furthermore, although EMI Limited and its American subsidiary, Capitol Industries-EMI, Inc. are convinced that they are immune from this burden under International law, they have had to proceed to the federal courts to vindicate their position, and those courts have not yet finally rendered judgment. The State of California does not agree that a distinction exists between foreign-based multinationals and domestically-based multinationals and wants to tax them all, in the same way. EMI Limited and Capitol Industries-EMI, Inc. therefore have that interest also in a decision from this Court which would eliminate the problem for all corporations engaged in foreign commerce.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted,

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Appendix A

Restatement of the Law, Foreign Relations Law
(Revised; Tentative Draft)

§ 412. The Basic Rule Applied

(1) A state has jurisdiction to tax the income of:

(a) persons (whether natural or juridical) who are nationals, residents, or domiciliaries of the state, whether the source of the income is within or without the state;

(b) natural persons present in the state, and natural or juridical persons doing business in the state (although not nationals, residents or domiciliaries of the state), but only with respect to income derived from or associated with presence or doing business within the state; and

(c) natural or juridical persons not nationals, residents or domiciliaries of the state and not present therein, only with respect to income derived from property located in the territory of the state.

(2) A state has jurisdiction to tax property located within its territory, without regard to the nationality, domicil, residence, or presence of the owner of the property.

(3) A state has jurisdiction to tax transfer of wealth (a) if the wealth consists of property located in its territory, or (b) as regards property not located in its territory, if the transfer is made by or to nationals, domiciliaries, or residents of the state.

(4) A state has jurisdiction to tax transactions which occur, originate or terminate in its territory or which have a substantial relation to the state, without regard to the nationality, domicil, residence or presence of the parties to such transactions.

Comment:

a. Implied limitations on jurisdiction to tax. The rules in this section affirming a state's jurisdiction to tax clearly imply some limitations on that jurisdiction: a state may tax a foreign company not having its headquarters in the state but doing business in the state on the income derived from that business, but not on its world-wide income (Subsection 1(b)); a state may tax persons not nationals, residents or domiciliaries of the state with respect to income derived from property in the state (Subsection 1(c)), but the existence of such property and income does not justify taxation of other property or income outside the state. These limitations are implied in the bases of jurisdiction required by § 402 and the principle of reasonableness in § 403.

The jurisdiction to tax *nationals, residents or domiciliaries* (Subsection (1)(a)) applies as well to complex commercial enterprises, permitting a state to tax a parent corporation on its world-wide income, including that of its branches and subsidiaries. (Emphasis ours.)

necessarily (assuming California is the only state in which U.S. operations are conducted) California will be taxing foreign source income as that term has been defined and recognized internationally for federal and foreign income tax purposes. In the context of harmonizing international tax systems among tax treaty partners, this is an unacceptable development.

Given the increasing values and geographic dispension of multinational business activities, and given the awareness by the Treasury of the accelerating force with which California reputedly has been applying the unitary tax method to worldwide operations, it is to the Treasury's credit that it has, by including Article 9(4) in the UK Treaty, asserted the federal prerogative over international tax relationships. Those relationships have a direct bearing on the conduct of foreign trade, on the balance of payments, and, indeed, on international relations.

* * * *

CONCLUSION

It clearly is in the national interest to ratify the UK treaty, including Article 9(4), and I urge this committee to recommend that it be so ratified. The concerns of the state of California and other states are by no means serious enough to warrant a reservation of Article 9(4) from the treaty, and thus deprive the nation as a whole from the benefits of that article.

I thank the Committee for its attention.

Appendix B

PREPARED STATEMENT OF CHARLES M. WALKER, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and members of this distinguished committee: I am pleased to appear here today to testify in support of the new income tax convention with the United Kingdom.

First, let me introduce myself. I am a lawyer residing and practicing in Los Angeles, California. I had the privilege of serving as Assistant Secretary of the Treasury for Tax Policy from early September, 1975, to January 20, 1977. One of the functions of my office was the negotiation of tax treaties and the preparation of treaty documents, protocols thereto, and notes exchanged thereon for signature by appropriate officials of our government. As a matter of fact, I had the privilege of appearing before this Committee on November 7, 1975, to present testimony in support of new tax treaties with Iceland, Romania, Poland, and the Union of Soviet Socialists Republics.

The income tax convention with the United Kingdom (which I will refer to as the United Kingdom Tax Treaty) had been negotiated before I assumed my duties with the Treasury Department. However, signature of the Treaty occurred thereafter, as did the exchange of notes thereon dated April 13, 1976.

* * * *

The unitary method employed by California is not used for federal or foreign tax purposes. Thus, if California's use of the unitary method produces an amount of taxable income for the subsidiary which exceeds the amount determined on a separate corporate and arm's length basis, then

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v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California

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BRIEF FOR FINANCIAL EXECUTIVES INSTITUTE AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a state transgresses the constitutional reservation to the national law-making body of the power "[t]o regulate Commerce with foreign Nations" when it taxes the income of a corporation with foreign affiliates by treating the entire corporate family as a unit, combining the separate incomes of all its members, and making an apportionment of the total to determine the state's share, in contradistinction to treating separate national corporate income accounts separately save as some reallocation may be needed to prevent distortion, which is the method of income taxation adopted by the national authorities of the United States and by the United States' foreign trading partners and which represents the international norm.

TABLE OF CONTENTS

	Page
Interest of Financial Executives Institute	1
Introduction and Summary of Argument	2
Argument	4
A State's Unitary, Combined-Reporting Apportionment of Worldwide Income Violates the Foreign Commerce Clause Because It Deviates From and Is Inconsistent With the International Norm of Separate-Source, Arm's-Length Allocation Adopted by the United States Government and Its Foreign Trading Partners	4
A. The Federal Government's Authority Over Foreign Commerce and International Affairs Is Preeminent and Exclusive	4
1. As this Court Has Recognized From the Earliest Days to the Present, the Need to Establish National Control of Foreign Trade and Other Intercourse Was a Principal Animating Reason for the Writing and Adoption of the Constitution	5
2. This Court Has Recognized the Paramount Role of the National Government in International Matters, Including Foreign Trade, as an Outgrowth of the Nation's Constitutional History	8
3. This Court in *Japan Line* Reaffirmed and Applied the Principles of Exclusive National Competence in Foreign Trade Matters in Invalidating a State Tax That Resulted in Taxation Duplicative of That of a Foreign Nation and Impaired the Ability of the United States to Speak With One Voice in Regulating Commercial Relations With Foreign Governments	10

TABLE OF CONTENTS—Continued

Page

B. Because It Deviates From the International Norm of Separate-Source, Arm's-Length Allocation Adopted by the United States and Other Nations, California's Worldwide-Combined-Reporting Method of Apportionment Violates the Foreign Commerce Clause 13

1. Congress Has Provided in the Relevant Provisions of the Internal Revenue Code for Separate-Source, Arm's-Length Taxation of Multinational Income 13

2. In Treaties as Well as in the Internal Revenue Code, the National Government Has Commited Itself to Separate-Source, Arm's-Length Accounting for Income Tax Purposes 17

3. California's Worldwide-Combined-Apportionment Method Results in Duplicative Taxation and Is at Odds With the Method of Allocating Income for Income-Tax Purposes Used by the United States and Its Trading Partners in the International Community 19

4. The Flaws That Inhere in the Worldwide-Combined-Apportionment Method Underscore Its Constitutional Impermissibility..... 24

Conclusion 29

TABLE OF AUTHORITIES

Cases: Page

American Chicle Co. v. *United States*, 316 U.S. 450 (1942) 15

ASARCO, Inc. v. *Idaho State Tax Comm.*, No. 80-2015 (U.S. June 29, 1982) 13, 28, 29

Associated Tel. & Tel. Co. v. *United States*, 306 F.2d 824 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963) 15

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U.S. 271 (1924) 28

Board of Trustees v. *United States*, 289 U.S. 48 (1933) 3, 5, 8

Brown v. *Maryland*, 25 U.S. (12 Wheat.) 419 (1827) 6

Burnet v. *Chicago Portrait Co.*, 285 U.S. 1 (1932) .. 15

Chase Brass & Copper Co. v. *Franchise Tax Board*, 400 U.S. 961 (1970) 1

Chicago Bridge & Iron Co. v. *Caterpillar Tractor Co., restored to the calendar for reargument*, No. 81-349 (O.T. 1981) 1, 23

Chinese Exclusion Case, The, 130 U.S. 581 (1889) .. 8

Chy Lung v. *Freeman*, 92 U.S. (2 Otto) 275 (1875) 9, 10

Commissioner v. *First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972) 16

Cook v. *Pennsylvania*, 97 U.S. (7 Otto) 566 (1878) 6

County of Mobile v. *Kimball*, 102 U.S. (12 Otto) 691 (1880) 9

Department of Revenue v. *Association of Washington Stevedoring Companies*, 435 U.S. 734 (1978) 8

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) 25

F. W. Woolworth Co. v. *Taxation and Revenue Department of New Mexico*, No. 80-1745 (U.S. June 29, 1982) 9

Hines v. *Davidowitz*, 312 U.S. 52 (1941) 8, 10

Inman Steamship Line v. *Tinker*, 94 U.S. (4 Otto) 238 (1876) 9

TABLE OF AUTHORITIES—Continued

	Page
Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979)	3, 6, 10-12, 19, 20, 21, 22, 25
Kassel v. *Consolidated Freightways Corp.*, 450 U.S. 662 (1981)	9
Kennecott Copper Corp. v. *State Tax Comm'n*, 409 U.S. 973 (1972)	1
Lewis v. *BT Investment Managers, Inc.*, 447 U.S. 27 (1980)	29
Maryland v. *Louisiana*, 451 U.S. 725 (1981)	23
Merrion v. *Jicarilla Apache Tribe*, 102 S. Ct. 894 (1982)	9
Michelin Tire Corp. v. *Wages*, 423 U.S. 276 (1976)	6, 9, 11, 23
Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980)	22, 28
Moorman Manufacturing Co. v. *Bair*, 437 U.S. 267, *leave to file briefs as amici curiae granted and reh. denied*, 439 U.S. 885 (1978)	1
National Paper & Type Co. v. *Bowers*, 266 U.S. 373 (1924)	14
New England Power Co. v. *New Hampshire*, 102 S. Ct. 1096 (1982)	29
Railroad Co. v. *Maryland*, 88 U.S. (21 Wall.) 456 (1874)	6
Reeves, Inc. v. *Stake*, 447 U.S. 429 (1980)	3, 10, 11
Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920)	21, 28
United States v. *Arjona*, 120 U.S. 479 (1887)	8
United States v. *Belmont*, 301 U.S. 324 (1937)	5, 8
United States v. *Curtiss-Wright Corp.*, 299 U.S. 304 (1936)	5, 9
United States v. *Pink*, 315 U.S. 203 (1942)	8
Zschernig v. *Miller*, 389 U.S. 429 (1968)	8, 10, 29

Constitution, statutes, treaties, and regulations:

U.S. Constitution:

Art. I, § 8, cl. 1	5
Art. I, § 8, cl. 3	5, *passim*
Art. I, § 8, cl. 10	5

TABLE OF AUTHORITIES—Continued

	Page
Art. I, § 10, cl. 2	5
Art. I, § 10, cl. 3	5
Art. II, § 2, cl. 2	5
Art. II, § 3	5
26 U.S.C.:	
§ 482	16, 17, 20
§§ 861-63	15
§§ 901 *et seq.*	15
§§ 7701(a)(3), (5)	15
Cal. Rev. & Tax. Code (West):	
§ 23151	2
§ 25101	2
§ 25102	2
§ 25128	2
1 CCH Tax Treaties:	
¶ 151 (OECD Model Income Tax Convention)	18
¶ 158 (Treasury Department's Model Income Tax Treaty)	18
¶ 171 (U.N. Model Income Tax Convention)	18
¶ 1203 (Canada)	17
¶ 2803 (France)	17
¶ 3003 (Germany)	17
¶ 4303 (Italy)	17
¶ 4393 (Japan)	17
2 CCH Tax Treaties:	
¶ 8103A (United Kingdom)	17
Treasury Regulations (26 C.F.R.):	
§ 1.482-1(b)(1)	16
§ 1.482-1(c)	17
Miscellaneous:	
Abel, *The Commerce Clause in the Constitutional Convention and in Contemporary Comment*, 25 Minn. L. Rev. 432 (1941)	6

TABLE OF AUTHORITIES—Continued

	Page
1 Beveridge, *The Life of John Marshall* (1916)	7
3 Bittker, *Federal Taxation of Income, Estates and Gifts* (1981)	14, 17
2 Bittker, Emory, & Streng, *Federal Income Taxation of Corporations and Shareholders* (*Forms*) (rev. ed. 1982)	13, 14, 15, 16
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S. Rep. No. 94-938, 94th Cong., 2d Sess. (1976)	15
State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. (1980)	19, 22, 23
State Taxation of Interstate Commerce: Hearings Before the Subcomm. on State Taxation of the Senate Comm. on Finance, 93d Cong., 1st Sess. (1973)	25
State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation of the Senate Comm. on Finance, 96th Cong., 2d Sess. (1980)	19, 23
Swisher, *American Constitutional Development* (2d ed. 1954)	7
Tax Conventions with Belgium, Finland, Trinidad and Tobago, and the Netherlands: Hearings Before the Senate Comm. on Foreign Relations, 91st Cong., 2d Sess. (1970)	14

TABLE OF AUTHORITIES—Continued

Page

Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. (1977) .. 19, 22, 25, 26, 27

Thompson, *Federal Income Taxation of Domestic and Foreign Business Transactions* (1980) 13, 14, 16

Warren, *The Making of the Constitution* (1937) .. 7

1 Watson, *The Constitution of the United States* (1910) 6

IN THE

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Appellee.

On Appeal from the Court of Appeal of the State of California

BRIEF FOR FINANCIAL EXECUTIVES INSTITUTE AS AMICUS CURIAE

INTEREST OF FINANCIAL EXECUTIVES INSTITUTE

Amicus Financial Executives Institute is the professional association of 12,000 senior financial and administrative officers of 6,000 organizations, large and small, throughout the United States and Canada. FEI's members represent a broad spectrum of commerce, trade, and industry. FEI has filed briefs as amicus curiae in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., restored to the calendar for reargument,* No. 81-349 (O.T. 1981); *Moorman Manufacturing Co.* v. *Bair,* 437 U.S. 267, *leave to file briefs as amici curiae granted and reh. denied,* 439 U.S. 885 (1978); *Kennecott Copper Corp.* v. *State Tax Comm'n,* 409 U.S. 973 (1972); and *Chase Brass & Copper Co.* v. *Franchise Tax Board,* 400 U.S. 961 (1970).

FEI members' companies do business in more than 125 foreign countries and in each of the 50 states, including California and other states that tax on the basis of a unitary, combined-reporting method for apportioning worldwide income. In addition, FEI members' companies

are involved in pending litigation concerning the validity and application of the worldwide-combined-reporting method. Accordingly, FEI is vitally interested in the sound and informed resolution of the constitutional issues raised by appellant.

The written consent of the parties has been obtained and is being filed with the Clerk of the Court.

INTRODUCTION AND SUMMARY OF ARGUMENT

Appellant Container Corporation of America is a corporation organized under the laws of Delaware with its principal executive offices in Illinois. (J.A. 6-7.) Container engages in business in California and other states of the Union. In addition, during the years in question here, Container had a controlling interest in a number of subsidiaries that were organized under the laws of, and did business in, foreign countries in Western Europe and Latin America. (J.A. 7, 14-15, 30.)

California imposes upon corporations doing business within the state a franchise tax based upon net income—a state income tax. *See* Cal. Rev. & Tax. Code § 23151 (West). In accordance with governing provisions of state law, *id.* §§ 25101, 25102, 25128, the California Franchise Tax Board determined Container's tax liability in the following way. First, it concluded that Container and its foreign subsidiaries constituted a unitary business enterprise. It then computed the combined worldwide income of Container and its subsidiaries. Next, the Board calculated Container's California income by apportioning a part of this total worldwide income to the state according to a three-factor formula. Finally, it applied to the calculated California income the California tax rate. The state courts rejected Container's federal constitutional challenges to this manner of determining its California income tax and sustained the validity of the worldwide-combined-reporting method of apportionment.

California's method of worldwide-combined-apportionment is unconstitutional under the Foreign Commerce Clause. Federal authority over foreign commerce and

international relations is "exclusive and plenary" and may not be "limited, qualified, or impeded to any extent by state action." *Board of Trustees* v. *United States*, 289 U.S. 48, 56-57 (1933). No less is demanded by the history and purpose of the relevant sections of the Constitution and the necessary role of our national government in its relations with other nations. As the Court has recently affirmed:

> "Foreign commerce is preeminently a matter of national concern. . . . [T]he Framers' overriding concern [was] that the Federal Government must speak with one voice when regulating commercial relations with foreign governments." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 448-49 (1979).

Accordingly, there is a "more rigorous" standard for judging the validity of state action that impinges on foreign commerce than state action that affects only interstate commerce, *Reeves, Inc.* v. *Stake*, 447 U.S. 429, 438 n.9 (1980). Even in the absence of affirmative federal preemption, the Commerce Clause serves to protect the preeminent power of the national government over foreign commerce by ensuring "federal uniformity . . . where federal uniformity is essential. . . . [The states] may not tell this Nation or [foreign countries] how to run their foreign policies." *Japan Line, Ltd.* v. *County of Los Angeles, supra*, 441 U.S. at 448, 455.

By statute and treaty, the United States and its foreign trading partners have adopted the method of separate-source, arm's-length allocation for taxing the income of multinational entities. In essence, this method consists of determining the national or geographic source of income for each separate taxpayer and, if necessary, reallocating income between related taxpayers as if they had dealt with each other at arm's-length. By these means, priority is given to the taxing authority of the jurisdiction in which income was earned, and duplicative taxation of income is avoided. The separate-source, arm's-length method is the prevailing international norm for the taxation of multinational enterprises.

In contrast, worldwide-combined-apportionment abandons altogether the approach of separate-source accounting and arm's-length reallocation. Instead, it assumes that income cannot be accounted for by source, and it seeks to apportion to a state a part of the combined worldwide income of the separate entities engaged in a unitary business. It does not recognize the separateness of taxing jurisdictions let alone give priority to the jurisdiction where income is earned, and it virtually ensures duplicative taxation of income. Thus, worldwide-combined-apportionment is irreconcilably at odds with the international standard of separate-source, arm's-length allocation.

The worldwide-combined-apportionment method adopted by California threatens to impair federal supremacy in this area and to disturb relations between the United States and foreign countries. Indeed, a number of foreign governments have already complained to the United States about the use of worldwide-combined-apportionment. Because of the severe problems it raises—including duplicative taxation, distortion and misapportionment of income, and onerous burdens of compliance—the California tax interferes with international trade and foreign affairs and should not be allowed to stand.

ARGUMENT

A STATE'S UNITARY, COMBINED-REPORTING APPORTIONMENT OF WORLDWIDE INCOME VIOLATES THE FOREIGN COMMERCE CLAUSE BECAUSE IT DEVIATES FROM AND IS INCONSISTENT WITH THE INTERNATIONAL NORM OF SEPARATE-SOURCE, ARM'S-LENGTH ALLOCATION ADOPTED BY THE UNITED STATES GOVERNMENT AND ITS FOREIGN TRADING PARTNERS

A. The Federal Government's Authority Over Foreign Commerce and International Affairs Is Preeminent and Exclusive

Few constitutional principles are as well-established as the preeminent authority of the federal government in the area of foreign commerce and international affairs. The Constitution expressly vests in Congress the

"Power . . . To regulate Commerce with foreign Nations . . . ." Art. I, § 8, cl. 3. Likewise, the federal government, acting through the President and the Senate, has the power "to make Treaties" with foreign nations. Art. II, § 2, cl. 2. And even where the Constitution is not explicit, the foreign-affairs power of the federal government has been recognized. *See, e.g., United States* v. *Curtiss-Wright Corp.*, 299 U.S. 304, 315-18 (1936); *United States* v. *Belmont*, 301 U.S. 324, 330-31 (1937).[1]

Concomitant with this authority conferred upon the federal government, the Constitution removes from the states the power to act in matters of international commerce and foreign relations. Thus, states are generally prohibited "without the Consent of the Congress" from laying "any Imposts or Duties on Imports or Exports," and any such duties or imposts that are allowed as "absolutely necessary for executing [a state's] inspection Laws" are expressly made "subject to the Revision and Controul of the Congress," with the revenues therefrom "for the Use of the Treasury of the United States . . . ." Art. I, § 10, cl. 2. Similarly, "[n]o State shall, without the Consent of Congress, lay any Duty of Tonnage," "enter into any Treaty, Alliance, or Confederation," or "enter into any Agreement or Compact . . . with a foreign Power . . . ." Art. I, § 10, cl. 3. These specific inhibitions underscore the majestically simple conferral on Congress of the affirmative and exclusive power to regulate commerce with foreign nations. *See, e.g., Board of Trustees* v. *United States*, 289 U.S. 48, 57 (1933).

1. *As this Court Has Recognized From the Earliest Days to the Present, the Need to Establish National Control of Foreign Trade and Other Intercourse Was a Principal Animating Reason for the Writing and Adoption of the Constitution*

The establishment of exclusive federal authority over foreign affairs, and especially foreign commerce, was a

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[1] With respect to federal authority over foreign commerce and international relations, *see also* Art. I, § 8, cl. 1; Art. I, § 8, cl. 10; Art. II, § 2, cl. 2; Art. II, § 3.

major reason for the adoption of the Constitution. As Chief Justice Marshall explained:

> "The oppressed and degraded state of commerce previous to the adoption of the constitution, can scarcely be forgotten. It was regulated by foreign nations, with a single view to their own interests; and our disunited efforts to counteract their restrictions, were rendered impotent, by want of combination. Congress, indeed, possessed the power of making treaties; but the inability of the federal government to enforce them had become so apparent, as to render that power in a great degree useless. Those who felt the injury arising from this state of things, and those who were capable of estimating the influence of commerce on the prosperity of nations, perceived the necessity of giving the control over this important subject to a single government. It may be doubted, whether any of the evils proceeding from the feebleness of the federal government [prior to the Constitution], contributed more to that great revolution which introduced the present system, than the deep and general conviction, that commerce ought to be regulated by congress." *Brown* v. *Maryland*, 25 U.S. (12 Wheat.) 419, 445-46 (1827). *See also Cook* v. *Pennsylvania*, 97 U.S. (7 Otto) 566, 574 (1878); *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 283 (1976).

At the time of the Convention, "the major concern was with extranational traffic, with only incidental and minor regard to interstate commerce. . . . [T]he major preoccupation [regarding trade and commerce] was with foreign trade and . . . the power over interstate commerce, while coordinate in expression, was distinctly secondary in scope and intended operation." Abel, *The Commerce Clause in the Constitutional Convention and in Contemporary Comment*, 25 Minn. L. Rev. 432, 465, 469 (1941), *cited with approval in Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 448 n.12 (1979). *See also* 1 Watson, *The Constitution of the United States* 479-80, 483 (1910); *cf. Railroad Co.* v. *Maryland*, 88 U.S. (21 Wall.) 456, 470 (1874).

The records of the adoption of the Constitution confirm the central importance of the establishment of federal authority over commercial and diplomatic relations with foreign governments. *See generally* 1 Beveridge, *The Life of John Marshall* 304-05, 308-12 (1916); Farrand, *The Framing of the Constitution of the United States* 5-12 (1913); Swisher, *American Constitutional Development* 25-27 (2d ed. 1954); Warren, *The Making of the Constitution* 567-90 (1937). *The Federalist Papers* reflect that importance. Madison thought that "[t]he powers delegated by the proposed Constitution to the Federal Government . . . will be exercised principally on external objects, as war, peace, negociation, and foreign commerce." *The Federalist* No. 45, at 313 (J. Cooke ed. 1961). As Madison observed, "[i]f we are to be one nation in any respect, it clearly ought to be in respect to other nations. . . . The regulation of foreign commerce . . . [is] properly submitted to the federal administration." *The Federalist* No. 42, at 279, 281 (J. Cooke ed. 1961). Hamilton also recognized the importance of this matter. He said that "[t]he want of a power to regulate commerce is by all parties allowed to be" one of "the defects . . . in the existing Federal system . . . which concur in rendering it altogether unfit for the administration of the affairs of the Union. . . . It is indeed evident, on the most superficial view, that there is no object, either as it respects the interests of trade or finance that more strongly demands a Federal superintendence." *The Federalist* No. 22, at 135-36 (J. Cooke ed. 1961). Without federal superintendence, he went on,

> "[n]o nation acquainted with the nature of our political association would be unwise enough to enter into stipulations with the United States, by which they conceded privileges of any importance to them . . . [because t]he treaties of the United States, under the present constitution, are liable to the infractions of thirteen different Legislatures . . . ." *Id.* at 136, 144. *See also id.*, No. 11, at 65 (Hamilton).

2. *This Court Has Recognized the Paramount Role of the National Government in International Matters, Including Foreign Trade, as an Outgrowth of the Nation's Constitutional History*

Consistent with our federal system of government and the history and intendment of the Constitution, this Court has long recognized the paramount role of the national government in international affairs:

> "[T]he supremacy of the national power in the general field of foreign affairs . . . is made clear by the Constitution, was pointed out by the authors of the Federalist in 1787, and has since been given continuous recognition by this Court . . . . The Federal Government, representing as it does the collective interests of the . . . states, is entrusted with full and exclusive responsibility for the conduct of affairs with foreign sovereignties. . . . Our system of government . . . imperatively requires that federal power in the field affecting foreign relations be left entirely free from local interference." *Hines* v. *Davidowitz*, 312 U.S. 52, 62, 63 (1941).[2]

What was said in general terms in *Hines* v. *Davidowitz* of the preeminence of federal power in international affairs is true in particular regard to the federal power over foreign commerce. We have quoted above from *Board of Trustees* v. *United States*, 289 U.S. 48, 56-57 (1933), the Court's forceful comment that the national power over foreign commerce is "exclusive and plenary" and "may not be limited, qualified or impeded to any extent by state action." The Court went on there to say:

> "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power. . . . [This] single con-

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[2] *See also, e.g.*, Department of Revenue v. Association of Washington Stevedoring Companies, 435 U.S. 734, 754, 758 (1978); Zschernig v. Miller, 389 U.S. 429, 440-41 (1968); United States v. Pink, 315 U.S. 203, 232-34 (1942); United States v. Belmont, 301 U.S. 324, 330 (1937); The Chinese Exclusion Case, 130 U.S. 581, 606 (1889); United States v. Arjona, 120 U.S. 479, 483 (1887).

trol . . . [of foreign commerce] was one of the dominant purposes of the Constitution to create." *Id.* at 59.[3]

For this reason, as the Court recently noted, "[t]he States . . . are subject to limitations on their taxation powers that do not apply to the Federal Government." *F.W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, No. 80-1745 (U.S. June 29, 1982), slip op. 8. And the Commerce Clause of its own force protects the paramount authority of the national government to regulate commerce even though the federal power has not been affirmatively exercised by the Congress or the Executive to limit the actions of the states. *See, e.g.*, *Kassel* v. *Consolidated Freightways Corp.*, 450 U.S. 662, 669 (1981) (plurality opinion); *Merrion* v. *Jicarilla Apache Tribe*, 102 S. Ct. 894, 910 (1982).

The broad federal authority over foreign commerce and international affairs reflects the realization that "[i]n this vast external realm" the Nation is confronted with "important, complicated, delicate and manifold problems . . . ." *United States* v. *Curtiss-Wright Corp.*, 299 U.S. 304, 319 (1936). The problems can only be exacerbated if states are allowed to chart their own course. As Hamilton cautioned, *The Federalist* No. 80, at 536 (J. Cooke ed. 1961), foreign powers have no special regard for our federal system and will hold the national government accountable for what the states do. In the context of disabling states from acting in foreign affairs, this Court has described the potential results of the accountability of the national government for the wrongs of member states. It has said that "'[e]xperience has shown that international controversies of the gravest moment, sometimes even leading to war, may arise from real or imagined wrongs to another's subjects inflicted,

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[3] *See also, e.g.*, Michelin Tire Corp. v. Wages, 423 U.S. 276, 285-86 (1976); County of Mobile v. Kimball, 102 U.S. (12 Otto) 691, 696-97 (1880); Inman Steamship Co. v. Tinker, 94 U.S. (4 Otto) 238, 245 (1876); Chy Lung v. Freeman, 92 U.S. (2 Otto) 275, 280 (1875).

or permitted, by a government.'" *Zschernig* v. *Miller*, 389 U.S. 429, 441 (1968), *quoting Hines* v. *Davidowitz*, 312 U.S. 52, 64 (1941). And if there should arise

> "a difficulty which would lead to war, or to suspension of intercourse, would California alone suffer, or all the Union? . . . [T]he power to regulate commerce with foreign nations . . . belongs solely to the national government. If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung* v. *Freeman*, 92 U.S. (2 Otto) 275, 279, 280 (1875).

It is natural, then, given the significance of the foreign commerce power to the adoption of the Constitution, the greater importance of foreign commerce than that of interstate commerce at the time the Nation was founded, and the recognition of the paramount authority of the federal government in all foreign affairs, that Commerce Clause inhibitions on state action are "more rigorous when a restraint on foreign commerce is alleged than when all that is involved is an interference with interstate commerce." *Reeves, Inc.* v. *Stake*, 447 U.S. 429, 438 n.9 (1980).

3. *This Court in* Japan Line *Reaffirmed and Applied the Principles of Exclusive National Competence in Foreign Trade Matters in Invalidating a State Tax That Resulted in Taxation Duplicative of That of a Foreign Nation and Impaired the Ability of the United States to Speak With One Voice in Regulating Commercial Relations With Foreign Governments*

The issue in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), was the validity of a California county's fairly apportioned tax on its small, transient share of the value of Japanese cargo containers that were used in international trade. The Court assumed that such a tax on containers in interstate commerce would have been constitutional, 441 U.S. at 445, 451. But the mere fact that Los Angeles County's tax was fairly proportional to the length of the containers' stay in the county was not enough to save it under the For-

eign Commerce Clause as it would have had only interstate commerce been involved. The duplication, however insignificant in amount, mattered in principle because "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 456. The Court emphasized that "[f]oreign commerce is preeminently a matter of national concern," and that, "[a]lthough the Constitution . . . grants Congress power to regulate commerce 'with foreign Nations' and 'among the several States' in parallel phrases, there is evidence that the Founders intended the scope of the foreign commerce power to be the greater." *Id.* at 448.

The *Japan Line* Court noted that the greater scope of the foreign commerce power—equivalent to the "more rigorous" standard of *Reeves, Inc.* v. *Stake, supra*—implicates at least two considerations in foreign commerce tax cases unique to them as opposed to interstate commerce tax cases. 441 U.S. at 446. One is the enhanced risk of double taxation that results from the inability of this Court or any other tribunal to ensure that, to take the example then at hand, other jurisdictions capable of taxing the containers would defer to Los Angeles County's fairly apportioned tax. *Id.* at 447, 454. The other is the necessity of barring exertions of state taxing power that would prevent "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Id.* at 451, *quoting Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976).

The fairly apportioned Los Angeles County tax both resulted in double taxation and prevented the Nation from speaking with one voice in regulating foreign commerce.

It resulted in double taxation because Japan—as was its right under the custom of nations as the country of domicile—taxed the containers on their full value with no allowance for even the most fairly apportioned tax

levied by some jurisdiction through which they passed. 441 U.S. at 447, 451-52, 454.

The Los Angeles County tax also prevented the United States from speaking with one voice to interested foreign powers. The United States and Japan were parties to a customs convention on containers, which "reflect[ed] a national policy to remove impediments" to international traffic and under which American containers were not taxed in Japan. *Id.* at 453. The Court found that in these circumstances "California's tax . . . will frustrate attainment of federal uniformity." *Ibid.* For one thing, the local tax on the containers "creates an asymmetry in international maritime taxation operating to Japan's disadvantage." *Ibid.* The Court went on:

> "The risk of retaliation by Japan, under these circumstances, is acute, and such retaliation of necessity would be felt by the Nation as a whole. If other States follow California's example (Oregon already has done so), foreign-owned containers will be subjected to various degrees of multiple taxation, depending on which American ports they enter. This result, obviously, would make 'speaking with one voice' impossible. California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Ibid.*

The Customs Convention, it should be noted, applied only to federal and not to state taxes and therefore did not by its own force invalidate the California tax. *Id.* at 446 n.10. It was the prohibition, residing in the Commerce Clause, of state action that prevents the nation from speaking with one voice in matters of foreign trade that invalidated the Los Angeles County tax. The Court made clear that in this area the absence of express federal preemption of action by the states does not leave the states at liberty to act.

> "We find no merit in th[e] contention . . . that a State is free to impose demonstrable burdens on commerce, so long as Congress has not pre-empted the field by affirmative regulation. . . . California may

not tell this Nation or Japan how to run their foreign policies." *Id.* at 454-55.

B. Because It Deviates From the International Norm of Separate-Source, Arm's-Length Allocation Adopted by the United States and Other Nations, California's Worldwide-Combined-Reporting Method of Apportionment Violates the Foreign Commerce Clause

The California worldwide-combined-reporting method of apportionment is unconstitutional under the Foreign Commerce Clause.[4] Congress, by statute and treaty, has adopted a different method—the separate-source, arm's-length allocation method—that accords with the custom of nations and is inconsistent with the use of the world-wide-combined-reporting method by any of the states. California's method, moreover, results in double taxation and has other conceptual and practical flaws that aggravate the interference it works with federal regulation of international commerce.

1. *Congress Has Provided in the Relevant Provisions of the Internal Revenue Code for Separate-Source, Arm's-Length Taxation of Multinational Income*

The United States, like other nations, rests its jurisdiction to levy the national income tax on the domicile of the taxpayer and, where a domiciliary connection with the United States is lacking, on the fact that the source of the taxpayer's income is in the United States. *See, e.g.*, 2 Bittker, Emory, & Streng, *Federal Income Taxation of Corporations and Shareholders* (*Forms*) 17-3 to 17-4 (rev. ed. 1982); Thompson, *Federal Income Taxation of Domestic and Foreign Business Transactions* 512-14 (1980). Thus, natural persons who are citizens or permanent resident aliens and corporations that owe their existence to the laws of the United States or any of the states are obliged to pay tax to the United States on their

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[4] Because the California tax violates the Foreign Commerce Clause, it is unnecessary for the Court to decide whether it also offends the Due Process Clause. *See* ASARCO, Inc. v. Idaho State Tax Comm., No. 80-2015 (U.S. June 29, 1982), slip op. 20 n.14 (O'Connor, J., dissenting).

income whatever its geographical source. Non-resident aliens and foreign corporations that derive income from the United States are also subject to the federal income tax but only to the extent that their income does indeed find its source in the United States. In parallel fashion, foreign jurisdictions tax the income earned within their borders, including the foreign-source income of American corporations or foreign subsidiaries of American companies. Finally, to ensure that our domiciliaries are not penalized by the source-based taxing systems of other nations, the familiar foreign income tax credit provisions allow the domestic corporation that does business abroad —to take the most typical example and the relevant example for purposes of this case—to credit any taxes paid to foreign countries in respect of "income from sources without the United States" against what would otherwise be its United States income tax liability.

That description summarizes—and no doubt oversimplifies—many pages of technical provisions of the Internal Revenue Code. But it captures, we believe, the essence of separate-source income taxation, the system of income taxation that, in the interest of comity, of the security of multinational enterprises, and thus ultimately of world economic development, is pursued almost everywhere the world round.[5]

We elaborate only so far as necessary to provide authority for what we have just outlined by way of summary.

As this Court has said, "domestic corporations are required to pay a tax on their incomes from all sources." *National Paper & Type Co.* v. *Bowers*, 266 U.S. 373, 376 (1924). *See also* Bittker, Emory, & Streng, *supra*, at 17-4; Thompson, *supra*, at 512; 3 Bittker, *Federal Taxa-*

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[5] *See* Thompson, *supra*, at 557, *quoting* Draft Double Taxation Convention Report of the O.E.C.D. (1963); *Tax Conventions with Belgium, Finland, Trinidad and Tobago, and the Netherlands: Hearings Before the Senate Comm. on Foreign Relations*, 91st Cong., 2d Sess. 2 (1970) (statement of then Assistant Secretary of the Treasury Edwin S. Cohen).

tion of Income, Estates and Gifts ¶ 65.1, at 65-2 (1981). The rule, however, is subject to the allowance of a credit for taxes paid to foreign jurisdictions on income from sources without the United States. 26 U.S.C. §§ 901 *et seq.* The credit is also of long standing. This Court explained in a leading case that "the primary design of the [credit] provision was to mitigate the evil of double taxation" resulting from the overlapping jurisdiction of the United States and foreign countries to tax. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7 (1932); *see also id.* at 8-10 nn.6, 7; *American Chicle Co.* v. *United States*, 316 U.S. 450, 451 (1942); *Associated Tel. & Tel. Co.* v. *United States*, 306 F.2d 824, 832 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963). The Senate Committee on Finance more recently has explained that the "foreign tax credit system embodies the principle that the country in which a business activity is conducted . . . has the first right to tax the income arising from" that activity even if it is conducted by a company resident in another country. S. Rep. No. 94-938, 94th Cong., 2d Sess. 233 (1976). The country where the company resides "has a residual right to tax the income arising from" the activity in another country, but the country of the corporation's residence "recognizes the obligation to insure that double taxation does not result." *Ibid.* The United States uses the tax credit to satisfy that obligation by ensuring that income is taxed initially according to its source.

Foreign corporations "are ordinarily not taxed [in the United States] on their foreign-source income . . . ." Bittker, Emory, & Streng, *supra*, at 17-3. The Congress has defined "domestic" corporations and "foreign" corporations. 26 U.S.C. §§ 7701(a)(3), (5). Moreover, it has established source-of-income and source-of-deduction rules, 26 U.S.C. §§ 861-63, which determine "[t]he geographical source" of income and deductions, Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.02, at 17.09 (4th ed. 1979). By these rules, the foreign-source income of foreign corporations is distinguished from their United States-source income and

left to be taxed by the appropriate foreign jurisdiction. Thompson, *supra*, at 514. Thus, because the United States defers to the source jurisdiction's taxation of the foreign-source income of foreign corporations, inconsistent treatment and multiple taxation are avoided. These rules apply even if the foreign corporation is "wholly owned by U.S. shareholders." Bittker, Emory, & Streng, *supra*, at 17-3. It is only when "the foreign income is repatriated in the form of dividends to U.S. shareholders" that "it will be subjected to U.S. taxation . . . ." *Ibid.* And in that event, the United States allows, in accordance with the credit provisions already discussed, "a credit for foreign income taxes . . . paid when the income was earned in the foreign jurisdiction." *Ibid.*

The separate-source system, then, is quite simple. It is complicated only by the fact that the geographical source of income earned by a multinational enterprise is not always self-evident.

To protect the integrity of the source rules for taxing income, Section 482 of the Code authorizes the Internal Revenue Service to reallocate income between two or more entities owned or controlled by the same interests if "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such [entities]." 26 U.S.C. § 482. *See Commissioner* v. *First Security Bank of Utah, N.A.*, 405 U.S. 394, 400 (1972). When any reallocation has to be made, it is done by treating the commonly owned or controlled entities as if they had dealt with each other at arm's length. As explained in the Treasury regulations implementing Section 482:

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . *The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.*" Treas. Reg. § 1.482-1(b)(1) (emphasis added).

Arm's-length reallocation pursuant to Section 482 is authorized in "any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(c). The obvious case, and the case where the IRS has employed Section 482 most extensively in recent years, is that of a foreign corporation selling products to an affiliated domestic corporation at spurious prices that result in larger profits abroad, thereby producing smaller profits and smaller taxable income in the United States. *See* 3 Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 79.1, at 79-2 (1981).

2. *In Treaties as Well as in the Internal Revenue Code, the National Government Has Committed Itself to Separate-Source, Arm's-Length Accounting for Income Tax Purposes*

In addition to their inclusion in the Internal Revenue Code, the two fundamental standards of federal taxation of multinational enterprises—(1) avoidance of multiple taxation by deference to the taxing authority of the jurisdiction where the income originated (geographical-source allocation), and (2) where necessary, arm's-length reallocation to determine the true income for commonly controlled taxpayers (arm's-length accounting)—are also embodied in international tax treaties. They are the standards of the tax treaties between the United States and its trading partners, such as Canada, France, Germany, Italy, Japan, and the United Kingdom.[6]

The Treasury Department's Model Income Tax Treaty "for the Avoidance of Double Taxation and the Preven-

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[6] *See* 1 CCH Tax Treaties, *e.g.*, ¶ 1203 (Canada) (*see also* ¶ 1301); ¶ 2803 (France); ¶ 3003 (Germany); ¶ 4303 (Italy); ¶ 4393 (Japan); 2 CCH Tax Treaties ¶ 8103A (United Kingdom).

Appellant has stated that the arm's-length method was used in those foreign countries in which its subsidiaries operated. *See* J.S. 8.

tion of Fiscal Evasion With Respect to Taxes on Income and Capital" provides that business profits arising in a foreign country may be taxed in that country and that the domiciliary country of the taxpayer will not impose a second tax on that income. 1 CCH Tax Treaties ¶ 158, at 257 (Art. 7), 263 (Art. 23) (1981). The Treasury Model Treaty, having thus described the separate-source method, goes on to describe the arm's-length reallocation: for "associated enterprises" between which "conditions are made or imposed . . . in their commercial or financial relations which differ from those which would be made between independent enterprises, . . . any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly." *Id.* at 258 (Art. 9). *See also id.* at 257 (Art. 7). Similar provisions are also contained in the "Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital" of the Organization for Economic Co-operation and Development (of which the United States is a member)[7] and in the United Nations "Model Double Taxation Convention Between Developed and Developing Countries."[8]

In view of the foregoing, it is clear that separate-source, arm's-length allocation is the prevailing international norm adopted by the United States and its international trading partners. As Assistant Secretary of the Treasury Woodworth explained:

> "The Federal Government and virtually all other governments in the world determine taxable income on the basis of what are arm's length transactions in dealings between related companies. This is the general rule.
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> * * * * *
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> [T]he arm's length rule is generally applicable in the world today . . . . [It is] the general rule with

[7] 1 CCH Tax Treaties ¶ 151 (1980).

[8] 1 CCH Tax Treaties ¶ 171 (1982).

> which [other countries and companies of other countries] are acquainted [and is] used by the Federal Government. . . .
>
> • • • • •
>
> [T]he Federal Government, and practically all of the rest of the world, uses the arm's length procedure." [9]

3. *California's Worldwide-Combined-Apportionment Method Results in Duplicative Taxation and Is at Odds With the Method of Allocating Income for Income-Tax Purposes Used by the United States and its Trading Partners in the International Community*

In the face of this international acceptance of the separate-source, arm's-length method, California's unitary, combined-reporting apportionment of worldwide income cannot be allowed to stand. Like Los Angeles County's fairly apportioned property tax, it must be condemned under the Foreign Commerce Clause because it "impair[s] federal uniformity in an area where federal uniformity is essential" and "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 448, 451 (1979).

The California method of apportionment includes the earnings of foreign subsidiaries in the combined worldwide total of income to be apportioned. The result is to impose a tax on income that has already been taxed by

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[9] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 20-21, 24 (1977); *See also id.* at 33, 105; *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation of the Senate Comm. on Finance*, 96th Cong., 2d Sess. 44 (1980) (statement of then Assistant Secretary of the Treasury Donald C. Lubick); *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 4, 5, 7, 9 (1980) (statement of Assistant Secretary Lubick).

the source jurisdiction abroad on an unapportioned, full-value basis. (*See* pp. 14, 16 *supra.*) Thus, as in *Japan Line, Ltd.* v. *County of Los Angeles*, *supra*, a second tax on the identical income "inevitably results . . . if a State should seek to tax . . . [that foreign-source income] on an apportioned basis," 441 U.S. at 447, and this is true even though the state tax is " 'fairly apportioned,' " *id.* at 448.[10]

Nor can it be said—recognizing that the duplication is likely to be of the greatest concern to the other members of the international community when a foreign parent's income is attributed to a California subsidiary—that this duplicative tax is of no concern to the foreign-source country even in the case of a United States parent with a foreign subsidiary. In comparison to separate-source accounting, California's method of taxation will discourage foreign investment by United States companies and make it less likely that they will establish foreign subsidiaries. Consider an example in which no arm's-length adjustment is needed between a domestic parent and its foreign subsidiary because the intrafamily transfer prices fairly approximate arm's-length prices.[11] If the unitary, combined-reporting system attributes to California an amount of foreign-source income that has been fully taxed by the foreign jurisdiction, then this duplicative tax by the state will require the overall operation of the parent and subsidiary to be more profitable than it would have to be under the separate-source method in order to produce the same total after-tax income. Such a disincentive to United States investment abroad, as a conse-

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[10] In this case, appellant's foreign subsidiaries paid taxes in the foreign countries on the amounts earned in each country (J.A. 72). Nevertheless, California "attribute[d] to other countries approximately one-half of the income produced in Colombia and Venezuela according to arm's-length principles applied in those countries" (J.S. 11).

[11] In this case, the Internal Revenue Service audited Container for the years in question here. It accepted Container's income figures as accurate and proposed no adjustments to income or deductions under § 482. (J.A. 78-79.)

quence of the application of the combined-reporting method instead of the separate-source standard, would surely be of considerable importance to foreign governments. And any repatriation of funds to the United States necessary to satisfy the duplicative state tax could well interfere with the internal policies of foreign-source countries in such areas as the development and retention of capital for local reinvestment by the subsidiary itself or by foreign minority shareholders.[12]

Beyond duplication of tax is the effect of the California method in preventing the United States from speaking with one voice. The "custom of nations," 441 U.S. at 447, 454, in this area—deviated from only by the world-wide-combined-reporting states[13]—is to avoid overlapping or duplicative taxation of the same income by according priority to the jurisdiction that is the source of income and reallocating income, when required to avoid distortion, on an arm's-length basis. In essence, this approach rests on the determination of the geographic source of income for each separate taxpayer and, if necessary, the arm's-length readjustment of income between related taxpayers.

In contrast, the central premise of unitary, combined-reporting apportionment is that most "income . . . cannot be satisfactorily allocated by source," J. Hellerstein & W. Hellerstein, *State and Local Taxation* 399 (4th ed. 1978)—in other words, "the impossibility of allocating specifically the profits earned by the processes conducted within [the state's] borders," *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920). Under this system, the worldwide business income of the entire multinational unitary enterprise is combined in a single total

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[12] We note that a substantial number of appellant's overseas subsidiaries had foreign minority stockholders—in some cases as much as 33% of total ownership. (J.A. 7, 14-15.)

[13] FEI estimates that approximately 10 states have adopted a system of worldwide-combined-apportionment. *Compare* Japan Line, Ltd. v. County of Los Angeles, *supra*, 441 U.S. at 453 & n.19.

and then apportioned to California according to a three-factor formula, that is, according to how much the California part of the enterprise represents of its total property, payroll, and sales. (*See* J.S. App. A6 n.2.) It is thus apparent that California's unitary, combined-reporting apportionment of worldwide income is irreconcilably at odds with the international standard of separate-source allocation. As the Court observed in *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 444-45 (1980), "[t]axation by apportionment and taxation by allocation to a single situs are theoretically incommensurate, and if the latter method is constitutionally preferred, a tax based on the former cannot be sustained." The Court held that specific allocation was not constitutionally preferred in the circumstances of that case. Here it must be preferred because state unitary taxation of worldwide income "is not ceding the primacy of foreign source income . . . to the foreign government." *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 10 (1980) (hereinafter *Foreign Source Income Hearings*) (statement of then Assistant Secretary of the Treasury Donald C. Lubick).

Moreover, California's method "creates an asymmetry in international . . . taxation," 441 U.S. at 453, that threatens to impair federal supremacy in this area and to disturb relations between the United States and foreign countries. As Assistant Treasury Secretary Woodworth noted, "it becomes very disconcerting for other countries and for companies of other countries doing business in the United States to have the general rule [of separate-source accounting] with which they are acquainted used by the Federal Government and to find that certain State governments do not follow that rule. . . . [I]t is important that we all use the same test." *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 21, 24 (1977) (hereinafter *Tax Treaties Hearings*);

see also id. at 33. In fact, the state "practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method which is used by the Federal Government and is generally accepted in international practice." *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation of the Senate Comm. on Finance*, 96th Cong., 2d Sess. 44 (1980); *see also Foreign Source Income Hearings* 5, 7 (statement of Assistant Secretary Lubick).[14]

We recognize, of course, that the problems caused by worldwide-combined-apportionment are exacerbated in the case of a foreign parent corporation with a domestic subsidiary doing business in California. But application of the California tax even to a domestic parent and its foreign subsidiaries, which is what this case involves, interferes with the federal government's authority over international trade and diplomatic affairs and therefore is unconstitutional under the Foreign Commerce Clause.[15]

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[14] The background and details of these protests by foreign governments are set out in the Brief for Appellant (at 23-28) and the Memorandum for the United States as Amicus Curiae (at 16-17) in Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., No. 81-349 (O.T. 1981).

[15] In addition, to create a special rule that discriminates against domestic companies in favor of foreign organizations would be a misguided construction of the Constitution, since the Commerce Clause "cannot be read to accord . . . [foreign entities] preferential treatment." Michelin Tire Corp. v. Wages, *supra*, 423 U.S. at 287. *See also* Maryland v. Louisiana, 451 U.S. 725, 754 (1981) (the Commerce Clause contains an "antidiscrimination principle [which] 'follows inexorably from the basic purpose of the Clause' to prohibit the multiplication of preferential trade areas destructive of free commerce anticipated by the Constitution").

4. *The Flaws That Inhere in the Worldwide-Combined-Apportionment Method Underscore Its Constitutional Impermissibility*

California, one may concede, is seeking only to tax its fair share of the income of Container Corporation and other companies that do business both in California and in foreign lands. Within the community of the states of the Union, the method it has chosen, we may assume, would be a permissible one because any distortions it would yield are likely to be within tolerable bounds and this Court sits to ensure that California and its sister states do not unduly burden or discriminate against businesses that operate across state lines. In this case, however, the Court's writ runs only to California and not to the nations whose taxing systems would have to be accommodated to California's if the California system were allowed to stand.

Moreover, the distortions that system yields, when applied beyond the borders of the United States, far exceed tolerable limits. The California method, in short, cannot be defended on the ground that, though different from the federal and the international system, it comes out at about the same place. The California method is not calculated to produce a fair or reasonable result when applied to income earned abroad.

Worldwide-combined-apportionment is impermissibly susceptible of seriously distorting the income attributed to the jurisdiction using the method. "The underlying premise of formulary apportionment under the . . . three-factor formula is that . . . , by and large, every dollar of wages or property spent in one taxing jurisdiction, along with receipts from sales in the area, will produce the same amount of profit in all taxing jurisdictions." J. Hellerstein & W. Hellerstein, *supra*, at 539. As the Treasury Department has correctly pointed out, "[i]mplicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always

the same." *Tax Treaties Hearings* 34 (statement of Assistant Secretary Woodworth).

Whatever the validity of formula apportionment within the largely-homogeneous United States, this approach is unsound and arbitrary in the international context.[16] As Assistant Treasury Secretary Woodworth explained, it is

> "clearly not the case [that multinational profit rates are the same]. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation." *Tax Treaties Hearings* 34; *see also id.* at 21, 24; J. Hellerstein & W. Hellerstein, *supra*, at 539; H.R. Rep. No. 1480, 88th Cong., 2d Sess. 168 (1964); *State Taxation of Interstate Commerce: Hearings Before the Subcomm. on State Taxation of the Senate Comm. on Finance*, 93d Cong., 1st Sess. 160 (1973) (statement of Professor Jerome R. Hellerstein).[17]

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[16] In the context of interstate commerce, "a State may apply an apportionment formula to the taxpayer's total [unitary] income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'" Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207, 223 (1980). In the case of foreign commerce, however, "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 456 (1979).

[17] *See also GAO Report on Determining the Income of Multinational Corporations*, App. IX, at 93 (Sept. 30, 1981) (letter from Assistant Secretary of the Treasury John E. Chapoton) ("formula apportionment has little merit because a corporation could have an increased tax burden merely as a result of its affiliates becoming more profitable or as a result of paying higher wages in the jurisdiction applying the formula").

Such a misapportionment of worldwide income can occur for any reason that causes the overseas operations to be more profitable than domestic operations. One well-recognized example is the significant disparity around the world in wage rates and payroll costs—one of the factors employed in California's apportionment formula. Once again, this has been acknowledged by the Treasury Department:

> "[L]abor costs vary substantially among countries—very much more so than among regions in the United States . . . . [The foreign] labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California." *Tax Treaties Hearings* 34 (statement of Assistant Secretary Woodworth).

Indeed, the record in the instant case clearly proves this defect in worldwide apportionment. It was demonstrated below that Container's overseas businesses were more profitable than its United States business. (*See* J.S. 18-19.) Expert testimony also illustrated the reasons why corporate operations abroad are in general more profitable than domestic operations. (*See* J.S. 19-20.) And, with particular regard to wage rates, Container showed that its "workers in California are paid 2½ times the amount paid to workers in Colombia to produce the same quantity of . . . containers" (J.S. 18), that worldwide wage rates vary widely and that wage rates in the United States exceed those in other countries (J.S. 18 & n.11; J.S. App. A41-A42), and that in 1969-70 the average hourly worker compensation in *developed* countries, *as adjusted for differences in productivity*, was only 40 to 82 percent of the average hourly compensation in the United States (J.S. 18 & n.11; J.S. App. A43).

Such misapportionment is objectionable on several grounds. As Assistant Treasury Secretary Woodworth observed, it allows the state effectively to tax the foreign-source income of a foreign corporation over which the state would not otherwise have jurisdiction. It also is

manifestly unfair to the domestic taxpayer to be required to pay taxes on the foreign-source income of a separate corporate entity. And, of particular significance for purposes of the Foreign Commerce Clause, it discourages American investment in countries in which the profitability rate is significantly different than in the United States and thereby discriminates against those countries (generally the developing countries) in favor of nations (generally the industrialized nations) where profitability is more comparable to that in the United States.

Furthermore, worldwide-combined-apportionment raises insurmountable problems of application. It requires that corporate books and records from all over the world be converted from foreign currencies and accounting practices into United States dollars and accounting conventions. The burden of such an undertaking can be enormous,[18] and the results of the conversion are often, at best, arbitrary and inexact. *See* J. Hellerstein & W. Hellerstein, *supra*, at 539; *Tax Treaties Hearings* 34 (statement of Assistant Secretary Woodworth). In fact, the record in this case discloses that "[a]ccounting procedures and methods [for Container and its foreign subsidiaries] were far from standardized . . . . The books and records of the foreign subsidiaries are kept in accordance with the generally accepted accounting principles, if any, of the country in which the subsidiary is located. These accounting principles may vary in material respects from generally accepted accounting principles in the United States." (J.A. 40, 72. *See also* J.S. App. A29.)

Undoubtedly, of course, foreign subsidiaries already supply some information to their domestic parent in a form in which these conversions have been made. But

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[18] *See Tax Treaties Hearings* 105 (letter from Secretary of the Treasury Blumenthal). Moreover, because of foreign laws prohibiting or restricting the disclosure of certain information, it is sometimes not possible to provide the information required by the taxing state. *Ibid. See also Tax Treaties Hearings* 213 (statement of Valentine Brookes) (United Kingdom Official Secrets Act).

that process—which certainly varies for each company—is a far cry from the detailed and voluminous material on property, payroll, and sales necessary for California to apply its method of worldwide-combined-apportionment. Moreover, under the theory that the separate corporations are part of a unitary business enterprise, the combined-reporting system eliminates all intra-enterprise dealings and transactions between these entities. *Cf. ASARCO, Inc.* v. *Idaho State Tax Comm.*, No. 80-2015 (U.S. June 29, 1982), slip op. 5; *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 441 n.15 (1980). To effect the required elimination would impose on a taxpayer an extraordinary burden, well beyond anything corporations usually do in the ordinary course of business.

For all these reasons, the worldwide-combined-reporting method of apportionment violates the Foreign Commerce Clause.[19] Congress, we may assume, could authorize the states to apply worldwide-combined-apportionment—despite its inconsistency with Congress' own chosen method and despite its inherent defects—for "Congress, if it chooses, may exercise [its Commerce Clause] power . . . by conferring upon the States an ability to restrict the flow of . . . commerce that they would not otherwise

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[19] The validity of the California tax is not saved by the decision of this Court in Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924). *Bass* presented no conflict between state apportionment of worldwide income and the international norm of separate-source, arm's-length accounting, since it was not until "1934 [that] the Department of the Treasury adopted the 'arm's length standard' for allocating income." *GAO Report on Determining the Income of Multinational Corporations*, at 2 (Sept. 30, 1981). The ensuing development of tax treaties and the international acceptance of the arm's-length method that now prevails make the instant case a much different one than *Bass*. Moreover, *Bass* was "controlled," 266 U.S. at 280, by the decision in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920), which involved the apportionment of interstate income; but as the Court has now held (*see* pp. 10, 11, 25 n.16 *supra*), a more rigorous test is applicable to foreign commerce than to interstate commerce. Finally, unlike the instant case, the taxpayer in *Bass* had "not even attempted to show," 266 U.S. at 282, any misapportionment of income.

enjoy." *Lewis* v. *BT Investment Managers, Inc.*, 447 U.S. 27, 44 (1980). *See also New England Power Co.* v. *New Hampshire*, 102 S. Ct. 1096, 1101 (1982); *ASARCO, Inc.* v. *Idaho State Tax Comm., supra*, slip op. 20 n.14 (O'Connor, J., dissenting). But, "[i]f there are to be such restraints, they must be provided by the Federal Government." *Zschernig* v. *Miller*, 389 U.S. 429, 441 (1968). Unless and until Congress grants this authority, the states may not depart from the international norms of commerce recognized by the United States and its trading partners.

CONCLUSION

The California method of unitary, combined-reporting apportionment of worldwide income is unconstitutional under the Foreign Commerce Clause. Accordingly, the judgment below should be reversed.

Respectfully submitted.

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District.

BRIEF OF AMICUS CURIAE ON THE MERITS IN SUPPORT OF APPELLANT, SUBMITTED ON BEHALF OF THE FIRESTONE TIRE & RUBBER COMPANY.

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TABLE OF CONTENTS

	Page
Introductory Statement	1
Interest of Amicus Curiae	1
Preliminary Statement	2
Argument	4
A. Primary Issue	4
B. Issue of First Impression	4
C. The Due Process Clause	6
D. The Commerce Clause	8
E. The Supremacy Clause	18
Conclusion	24

TABLE OF AUTHORITIES

Cases	Page
Asarco Inc. v. Idaho State Tax Commission, ... U.S. ..., (Docket No. 80-2015, 6/29/82)	7, 8
Bass, Ratcliff and Gretton v. State Tax Commission, 266 U.S. 271, 69 L.Ed. 282 (1924)	2, 3
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L.Ed.2d 326 (1977)	9
Connecticut General Life Insurance Co. v. Johnson, 303 U.S. 77, 82 L.Ed. 673 (1938)	6
Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 65 L.Ed.2d 66 (1980)	7, 8
F.W. Woolworth Co. v. Tax and Rev. Department of New Mexico, ... U.S. ... (Docket No. 80-1745, 6/29/82)	7, 8
International Harvester Co. v. Evatt, 329 U.S. 416, 91 L.Ed. 390 (1947)	9
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 60 L.Ed.2d 336 (1979)	10, 11, 20, 21
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 63 L.Ed.2d 510 (1980)	5, 6, 7, 8
Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978)	6, 9
National Bellas Hess v. Illinois, 386 U.S. 753, 18 L.Ed.2d 505 (1967)	8
Norfolk & Western Railway Company v. Missouri State Tax Commission, 390 U.S. 317, 19 L.Ed.2d 1201 (1968)	6, 9, 10
Norfolk & Western Ry. Co. v. North Carolina, 297 U.S. 682, 80 L.Ed. 977 (1936)	9
United States v. Belmont, 301 U.S. 324, 81 L.Ed. 1134 (1937)	24

Page

United States v. Curtiss-Wright Export Corp., 299 U.S. 304, 81 L.Ed. 255 (1936) 10, 24

Zschernig v. Miller, 389 U.S. 429, 19 L.Ed.2d 683 (1968) 23

Articles

Blough and Wagner, "U.S. Income Tax Treaty With the United Kingdom: Evaluation of Its Benefits to the United States Including Reasons for Approving the Constraints It Places on State Use of Unitary Apportionment", U.S. Dept. of Commerce: Foreign Business Practice Div.-Office of International Finance and Investment Industry and Trade Administration (April 19, 1979) p. 16 21

Petersen, Robert A., "California Franchise Tax: Combined Income Report Affects Foreign Companies", The Journal of Taxation, March 1976, p. 184 ... 5, 6

Constitution

United States Constitution, Art. II, Sec. 2, cl. 2 .. 4, 23

United States Constitution, Art. II, Sec. 3 ..... 4, 23

United States Constitution, Art. VI, cl. 2 ..... 4, 23, 24

United States Constitution, Fourteenth Amendment ... 4

Miscellaneous

Income Tax Convention (April 27, 1932) United States-France, Art. IV, 49 Stat. 3145, TS No. 885 18

Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (Art. 7, Sec. 2; Art. 9, Sec. 1) 18

Report of the Committee on Foreign Relations of the United States Senate (Ex. Rpt. 96-5, June 15, 1979) p. 16 20

Page

"Tax Treaties With United Kingdom, the Republic of Korea and the Republic of the Philippines:" Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Sess., pp. 28, 33, 34 (1977) 18, 21, 23

"Transfer Pricing and Multinational Enterprises" Report of the OECD Committee on Fiscal Affairs (Paris, 1979), pp. 8, 9, 14, 15 ..... 19, 20

Statutes

75 Statutes at Large, p. 424 (22 U.S.C. §2351) 22

United States Code, Title 22, Sec. 2161 22

United States Code, Title 22, Sec. 2181 22

Treaties

United States-Argentina (12/5/61) 12 U.S.T. 955 22

United States-France (7/25/39) Art. 3, 125 UNTS 259 19

United States-Italy (10/18/57) 8 U.S.T. 1881 22

United States-Mexico (4/6/54) 5 U.S.T. 1373 22

United States-New Zealand (3/16/48) Art. 3, para. 1, 2 U.S.T. 2378 19

United States-Pakistan (7/1/57) Art. 3, para. 2, 10 U.S.T. 984 19

No. 81-523

IN THE

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

BRIEF OF AMICUS CURIAE ON THE MERITS IN SUPPORT OF APPELLANT, SUBMITTED ON BEHALF OF THE FIRESTONE TIRE & RUBBER COMPANY.

Introductory Statement.

This brief is submitted by The Firestone Tire & Rubber Company as *Amicus Curiae* in support of the appellant in the above-captioned case. Written consents of both appellant Container Corporation of America and appellee Franchise Tax Board are on file with the clerk of this Court.

Interest of Amicus Curiae.

Amicus, The Firestone Tire & Rubber Company ("Firestone"), whose corporate headquarters are at Akron, Ohio, the state of its incorporation, does business throughout the United States. It manufactures and sells "Firestone" — branded tires and other rubber-oriented products. Like Container Corporation of America ("Container"), Firestone too has been assessed deficiencies in tax by the State of California, on the basis of a worldwide combined report, wherein the three-factor formula of property, payroll and

sales has been applied to a tax base consisting of the combined incomes of Firestone and twenty-two foreign subsidiaries incorporated and doing business entirely outside the United States.

The constitutional validity of worldwide combined reporting is the subject of an appeal presently pending in the California Court of Appeal for the Second Appellate District (Los Angeles) in which Firestone is a party, involving income years 1960 through 1963. The primary issue in said appeal, known as *Firestone v. Franchise Tax Board* (2d Civil 62918), is whether California may constitutionally require Firestone to file its state franchise tax returns on a combined report basis with its twenty-two majority-owned foreign subsidiaries. Obviously, the disposition by this Court of the appeals in *Chicago Bridge & Iron Company v. Caterpillar Tractor Co.* (No. 81-349) and *Container Corporation of America v. Franchise Tax Board* (No. 81-523) will have a bearing on resolving the principles at issue in Firestone's own pending appeal.

Preliminary Statement.

This Court has not heretofore decided the precise issues involved in the instant appeal, namely, the validity, under the Commerce, Due Process and Supremacy Clauses of the United States Constitution, of worldwide combined reporting, wherein the incomes of a United States parent corporation and foreign subsidiaries which are incorporated and doing business wholly abroad are first combined together in a single tax base and then apportioned to the taxing state by some formulary method (typically, as in the case of California, by a three-factor formula consisting of property, payroll and sales.)

In *Bass, Ratcliff and Gretton v. State Tax Commission*, 266 U.S. 271, 69 L.Ed. 282 (1924), which is frequently

cited by state tax counsel as authorizing worldwide combined reporting, the question here at issue was neither addressed nor resolved. The taxpayer in *Bass* was a single corporate entity (a British-based manufacturer of ale) which did business *both* in Great Britain and, through various import agents, in the United States (in particular, the States of Illinois and New York.) This Court upheld the right of the State of New York to determine that portion of the taxpayer's business income earned within its borders by a formula method which was applied to a tax base consisting of the entire net profits of the taxpayer-corporation. In *Bass* a so-called "combined report" was not at issue, in view of the fact that it concerned only a *single* taxpayer which was itself amenable to the jurisdiction of the taxing state.

By contrast, worldwide combined reporting involves the inclusion in the tax base of a domestic taxpayer of the incomes of foreign corporations which have no nexus with the taxing state, do no business in the taxing state, and whose incomes are fully subject to tax by the foreign jurisdictions in which they are located.

ARGUMENT.

APPORTIONMENT BY FORMULA FOR STATE TAXATION PURPOSES OF A TAX BASE CONSISTING OF THE COMBINED INCOMES OF A UNITED STATES PARENT CORPORATION AND ITS FOREIGN SUBSIDIARIES INCORPORATED AND DOING BUSINESS EXCLUSIVELY ABROAD RESULTS IN GROSS DISTORTIONS OF INCOME IN FAVOR OF THE TAXING STATE IN VIOLATION OF THE DUE PROCESS CLAUSE AND IN DOUBLE TAXATION IN VIOLATION OF THE COMMERCE CLAUSE, AND INTERFERES WITH NATIONAL FOREIGN ECONOMIC POLICY OBJECTIVES IN VIOLATION OF THE SUPREMACY CLAUSE.

A. Primary Issue.

In this case the Court is asked to rule on the constitutionality of worldwide combined reporting. More specifically, the Court must determine whether the State of California may constitutionally apply its three-factor formula of property, payroll and sales to a tax base consisting of the combined incomes of a United States parent corporation and its separately incorporated foreign subsidiaries doing business wholly outside the United States, in order to apportion income for state taxation purposes. The relevant provisions of the United States Constitution include the Due Process Clause of the Fourteenth Amendment, the Commerce Clause insofar as it pertains both to interstate and to foreign commerce [Art. II, Sec. 2, cl. 2; Art. II, Sec. 3], and the Supremacy Clause [Art. VI, cl. 2].

B. Issue of First Impression.

This Court has not yet had occasion to pass upon the constitutional validity of worldwide combined reporting, in the face of a challenge to the fairness of a state apportion-

ment formula in a context where the pretax operating incomes of a United States parent corporation and its separately incorporated foreign subsidiaries have been combined in the apportionable tax base. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 63 L.Ed.2d 510 (1980), this Court held that dividend income *received in this country* by a parent corporation from its foreign subsidiaries could constitutionally be included in the tax base, absent an issue with respect to the "fairness" of the apportionment formula.

In *Mobil*, the taxpayer sought to raise an issue with respect to the "fairness" of the formula applied by the State of Vermont but the Court declined to reach it on the basis that it had not been presented to the state taxing authority, holding that "the evidence in the record is surely inadequate to evaluate . . . its potential implications." 63 L.Ed.2d, at p. 523, Footnote 15.

Worldwide combined reporting gives rise to a host of problems which are not present in a multistate context and which render it difficult, if not impossible, to apportion income fairly and equitably among taxing jurisdictions by a formulary method. Differing accounting systems, blocked currencies, devaluations, fluctuating exchange rates, wide variances in the risk factor, expropriations (both potential and actual), and foreign price and productivity controls give rise to irreconcilable problems in a worldwide context.

As noted by one commentator:

> ". . . the apportionment of income using a formula developed for use in the United States where business operations and the economy are somewhat uniform may not be a workable solution for companies operating under the laws of governments with entirely different business philosophies and practices and where the economies are substantially diverse." [Robert A.

Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies", *The Journal of Taxation*, March 1976, p. 184].

C. The Due Process Clause.

Both the Due Process Clause and Commerce Clause of the federal constitution prohibit a state from taxing tangible or intangible property which is unconnected with the taxing state. In *Norfolk & Western Railway Company v. Missouri State Tax Commission*, 390 U.S. 317, 19 L.Ed.2d 1201 (1968), this Court held:

> "The taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is his due. A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.' " *Id.*, at p. 325. cf. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

Nor, as a broad principle of constitutional law, may a state tax values earned outside its borders. *Connecticut General Life Insurance Co. v. Johnson*, 303 U.S. 77, 80-81, 82 L.Ed. 673 (1938)

The Due Process test is two-fold: it requires *first*, a minimal connection between the interstate (or multinational, as the case may be) activities and the taxing state and *second*, a "rational relationship" between the income attributed to the taxing state and the intrastate values of the enterprise which is taxed. *Mobil Oil Corp. v. Commissioner of Taxes*, 63 L.Ed.2d, at p. 520; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

The "linchpin of apportionability" for state income taxation of an interstate (or multinational, as the case may

be) enterprise is the "unitary-business principle." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at p. 439. For a "unitary" business to exist, however, it must be shown that contributions to income of the foreign subsidiaries sought to be unitized resulted from "functional integration, centralization of management and economies of scale." *Id.*, at p. 438. "Occasional oversight" with respect to matters affecting the capital structure, major debt, and dividends of majority-owned foreign subsidiaries does not, without more, satisfy either the "functional integration" or "centralized management" prerequisites. *F. W. Woolworth C[illegible] Tax. and Rev. Department of New Mexico*, Opinion p. 15 (Docket No. 80-1745, 6/29/82).

Functional integration is established where there is coordination and "controlled interaction" of the various operational functions of the business enterprise. *cf. Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 224, (1980); *Asarco Inc. v. Idaho State Tax Commission*, Opinion p. 12, footnote 13 (Docket No. 80-2015, 6/29/82). Where operational control is absent and the activities of the subsidiaries are, in a business and economic sense, "discrete business enterprises", there is no "unitary" relationship. *Asarco*, Opinion p. 21.

Mere "business advantage", or the fact that the business activities of the subsidiaries have "added to the riches" of the taxpayer corporation, are not dispositive of the unitary question. The proper focus is always on the "underlying unity or diversity" of the business enterprise, not whether "some economic benefit" has been derived by the taxpayer corporation. *Woolworth*, Opinion p. 9. Moreover, not the *potentiality for* but the *actuality of* operational control is dispositive. *Id.*, at p. 7.

The requisite connection must exist between the activities of the subsidiary to be unitized and the activities of the parent company taxpayer *in the taxing state*.

> "Where the business activities of the dividend payor have nothing to do with the activities of the recipient *in the taxing State*, due process considerations might well preclude apportionability, because there would be no underlying unitary business." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at p. 441-442; *cf. Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S., at pp. 223-224; *Asarco Inc. v. Idaho State Tax Commission*, Opinion p. 21. *Emphasis supplied.*

The proper focus of inquiry is " 'whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state . . . .' *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940)." *Asarco*, Opinion p. 8. If the state tax in question does not bear the "necessary relationship" to the "opportunities, benefits or protection" conferred or afforded by the taxing state, the tax fails to meet established due process standards in that the state is attempting to reach "extraterritorial values." *Woolworth*, Opinion p. 17.

Finally, the Due Process inquiry must be made on a case-by-case basis.

> ". . . the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing state." *Asarco*, Opinion p. 20, footnote 22.

D. The Commerce Clause.

The jurisdictional tests under the Due Process and Commerce Clauses of the federal constitution are closely related. *National Bellas Hess v. Illinois*, 386 U.S. 753, 756, 18 L.Ed.2d 505 (1967).

The primary focus of inquiry under the Due Process Clause is whether the tax in practical operation has relation to the opportunities, benefits or protections conferred by the taxing state. Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the state. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S., at p. 325, footnote 5.

Similarly, the focus under the Commerce Clause is to determine "what portion of an interstate organism may appropriately be attributed to each of the various states in which it functions." *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S., at p. 325, footnote 5. The practical effect of a tax is measured against the requirements that it be *applied to an activity with a substantial nexus with the taxing state, be fairly apportioned*, be non-discriminatory, and *be fairly related to the services provided by the state. Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L.Ed.2d 326, 331 (1977).

When a formula method is used to apportion income for state tax purposes, only "rough approximation" rather than absolute precision is required. *International Harvester Co. v. Evatt*, 329 U.S. 416, 422, 91 L.Ed. 390 (1947). Nevertheless, the amount of income apportioned to the taxing jurisdiction may not be out of "all reasonable proportion" to the business activities conducted within that jurisdiction. *Moorman Mfg. Co. v. Bair*, 437 U.S., at p. 274. A formula not arbitrary on its face or in its general operation may be unworkable or unfair when applied to a particular taxpayer under particular conditions. *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 685, 80 L.Ed. 977, 980 (1936). If it appears that the formula burdens the taxpayer with a result grossly in excess of a more accurate apportionment, the formulary method unconstitutionally reaches extraterritorial values. *Id.*, at p. 686.

Where the foreign commerce clause is concerned, two additional considerations come into play: the "enhanced risk of multiple taxation" at the international level and the potential impairment of uniformity "in an area where federal uniformity is essential." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 60 L.Ed.2d 336 (1979). The second consideration pertains likewise to the Supremacy Clause of the federal constitution and in recognizes that matters affecting the foreign affairs and foreign economic policies of the United States are vested by the Constitution exclusively in the federal government. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 316, 81 L.Ed. 255, 260 (1936).

Although formula apportionment may fairly reflect income in the context of a *multistate* business, when used in a worldwide context accompanied by combined reporting it produces results so far out of line with economic realities and with the prevailing method of taxation used by sovereign foreign nations that it clearly loses its value as a substitute for the "arms length" method of determining income for purposes of taxation. This Court said it best when it struck down an *ad valorem* property tax imposed by the State of Missouri on an interstate railroad operating within its borders:

> "The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product." *Norfolk & Western Ry. Co. v. Missouri Tax Comm.*, 390 U.S. at p. 327.

Thus, not only does the potential for interfering with the foreign economic policies and relationships of the United States exist when an individual state attempts to use world-

wide formulary apportionment, there is no authoritative tribunal (such as this Court in the context of a dispute between two or more states over the proper method of taxing the income of a multistate business) capable of insuring that the same income is not subject, by reason of diverse methodologies, to double taxation.

Indeed, the potential for, much less the actual occurrence of, international double taxation was sufficient for this Court to invalidate the tax at issue in *Japan Line, Ltd. v. County of Los Angeles*.

When the three-factor apportionment formula is applied to the pretax operating incomes of foreign subsidiaries in the context of the worldwide combined report, a gross misallocation of income inevitably results. Lower wage rates and property costs which have generally prevailed abroad since the end of World War II [Jt.App. 169, 182] cause the formula to *overstate* the amount of income earned in domestic state tax jurisdictions and to *understate* the income earned in foreign jurisdictions, in direct contrast to economic and financial realities. [Jt.App. 192]

One reason the three-factor formula is distortive in the international context is that it makes no accommodation for the risk factor associated with doing business abroad. There are three broad categories of risk at work in the foreign environment — "economic" (relating to marketplace considerations such as the size, strength and diversity of the foreign economy), "political" (pertaining to the type of government, commonality of institutions or lack thereof, and artificial impediments to economic equilibrium such as price controls, import restrictions and currency blockages) and "catastrophic" (pertaining to the threat of nationalization and expropriation which is an ever present concern in foreign jurisdictions.) [Jt.App. 155]

In the United States, deviations from the national average in profitability (rate of return), productivity, wage rates, and property values among different regions of the country tend to diminish over time due to the commonality of institutions (in the form of law, language and cultural heritage), homogeneity of the marketplace, and freedom of movement of capital and labor in this country. [Jt.App. 143] No such equilibrating forces are at work between sovereign foreign jurisdictions, with their own separate economic, political and nationalistic tendencies.

The increased risk factor associated with doing business in foreign jurisdictions translates in turn into higher rates of return (profitability) abroad "on the average and over the whole" as compared to the United States. [Jt.App. 147-148] The three-factor formula does not nor cannot take into account this risk factor in the apportionment of income for state taxation purposes.

The increased risks of doing business abroad likewise mandate a higher "hurdle" rate or minimum "expected" rate of return from foreign investments. [Jt.App. 135, 154] On the average and over the whole, actual (after-the-fact) rates of return abroad tend roughly to correlate with "expected" rates of return. If actual rates consistently exceeded expected rates, the perceived risk of doing business abroad would be lessened and more investment dollars would flow into the foreign area; conversely, if actual rates consistently fell short of expected rates, the "hurdle" rates would be driven higher.

This risk factor is intimately connected with the profitability of foreign investments and, by its inability to account for the risk factor phenomenon, the three-factor formula consistently *overstates* the amount of income attributable to a domestic state tax jurisdiction and *understates* the amount of income earned abroad.

Although the three-factor formula has no capacity to take the risk factor into account, the risk element *must* be taken into account when attempting to apportion by formula a tax base consisting in part of taxable income earned in foreign economies having a perceived risk factor which significantly exceeds that in the United States, and which carries with it higher actual rates of return or profitability.

The "reversal" phenomenon just described, wherein the formula allocates comparatively greater income to the place where costs are highest, rather than to where they are lowest, is illustrated in the three examples which follow. For purposes of the illustration it is assumed that a unitary business enterprise is comprised of a parent corporation doing business in California and a wholly-owned subsidiary which does business in Venezuela. Each company has one plant of approximately the same vintage (with an approximately equivalent net book value) and equal sales of 200 units per year, which produce $100 in net taxable income. The combined net income of the enterprise therefore is $200. In Example 1, all of the factors of the formula are equal and the productivity rate and operating expenses of the two companies are roughly equivalent. Applying the three-factor formula, 50% (or $100) of the combined taxable income of the enterprise is assigned to each jurisdiction (California and Venezuela), consistent with the books of the separate companies.

EXAMPLE 1

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 50	$100	.50
Payroll	50	50	100	.50
Sales	200	200	400	.50
		Average California Factor		.50

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(50)
Operating Expenses				
Fixed Costs (Incl. depreciation, rent, etc.)	$25		$25	
Variable Costs	25	(50)	25	(50)
Taxable Income		$100		$100

Combined Taxable Income — $200

Assignment of Income Per 3-Factor Formula

$$\frac{(.50 + .50 + .50)}{(\quad 3 \quad)} \times \$200 = \$100 \text{ (Calif. Taxable Income)}$$

$$= \$100 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100	50%	$100	50%	-0-
Venezuela	100	50%	100	50%	-0-

In Example 2, it is assumed that the prevailing wage rate at the California plant is ten times as great as that in Venezuela, while the payroll cost differential is offset only in part (by ½, or 50%) by the fact that the rate of productivity in California is twice that in Venezuela. All other factors remain constant.[1] Venezuelan profits increase from $100 to $140 in net taxable income; California remains at $100. The combined taxable income of the two companies is $240. The formula, however, assigns $146.40, or 61% of this

[1]In Example 2 it takes Venezuela $10 in payroll costs to produce $200 in sales (equivalent to sales in California), assuming a 1:10 ratio of Venezuela to California payroll (California payroll remains constant at 50), offset in part by a favorable rate of productivity in California of 2:1. But for the productivity offset, $10 in Venezuela payroll would have produced $400 in Venezuela sales (or, stated in another way, it would have taken $5 in Venezuela payroll to produce $200 in sales equivalent to California).

combined profit, to the State of California, whereas in economic reality only $100, or 41.67%, was actually derived there. This distortion in favor of California as a result of the formula is due solely to the differential in wage rates. Lower wage rates abroad inevitably result in a distortion of income in favor of California, when the formula is applied to the combined incomes of a domestic parent corporation and a foreign subsidiary corporation.

EXAMPLE 2

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 50	$100	.50
Payroll	50	10	60	.83
Sales	200	200	400	.50
		Average California Factor		.61

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(10)
Operating Expenses				
Fixed Costs	$25		$25	
Variable Costs	25	(50)	25	(50)
Taxable Income		$100		$140

Combined Taxable Income — $240

Assignment of Income Per 3-Factor Formula

$$\frac{(.50 + .83 + .50)}{(\quad 3 \quad)} \times \$240 = \$146.40 \text{ (Calif. Taxable Income)}$$

$$= \$93.60 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100	41.67%	$146.40	61%	46.40%
Venezuela	140	58.33%	93.60	39%	(33%)

Thus, whereas the Venezuelan books reflect a profit of $140, the formula assigns only $93.60 to Venezuela, which is only 67% of the profits actually earned there and which were subject to tax by Venezuela. The formula *overstates* the profit to California and *understates* the profit to the foreign country. This is exactly the opposite result one would expect in view of the lower wage rates prevailing abroad.

If the facts of the hypothetical are further modified to reflect a lower investment base in Venezuela as well as the payroll differential introduced in Example 2, the distortion in favor of California is even more emphatic, as illustrated by Example 3.

EXAMPLE 3

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 25	$ 75	.67
Payroll	50	10	60	.83
Sales	200	200	400	.50
		Average California Factor		.67

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(10)
Operating Expenses				
Fixed Costs	$25		$12.50	
Variable Costs	25	(50)	25.00	(37.50)
Taxable Income		$100		$152.50

Combined Taxable Income — $252.50

Assignment of Income Per 3-Factor Formula

$$\frac{(.67 + .83 + .50)}{(\quad 3 \quad)} \times \$252.50 = \$169.18 \text{ (Calif. Taxable Income)}$$

$$= \$83.32 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100.00	39.60%	$169.18	67%	69.18%
Venezuela	152.50	60.40%	83.32	33%	(45%)

In Example 3, the profit earned in California remains constant, since there was no change in any of the California factors from the previous examples. The Venezuelan plant is included in the denominator of the property factor at a lower value, reflective of the lower acquisition costs (hence a lower investment base or "net book value") generally prevailing abroad during the past several decades. The payroll factor is the same as in Example 2. The reduced investment base is reflected in reduced fixed costs which, in turn, increase the taxable profits of Venezuela from $140 to $152.50. The combined taxable income of the enterprise, or $252.50, is allocated by formula $169.18 to California (as compared to a book profit of $100) and $83.32 to Venezuela (as compared to a book profit of $152.50.) The formula thus allocates 67% of the combined income to California, whereas in economic reality only 39.6% thereof was derived there. Conversely, the formula allocates 33% of the combined income to Venezuela, whereas 60.4% thereof was actually derived in and was subject to tax by Venezuela. This 69% distortion in favor of California results from the fact that, when the investment base and payroll costs are lower abroad than in California, the denominators of the formula factors are smaller than they would have been had such costs been relatively equal, thereby increasing California's percentage of both the payroll and property factors of the combined group. Inevitably, the formula will assign a greater portion of the combined profits to California since California's combined factor in Example 3 is larger

than in either of the previous two examples. In economic reality, however, it was only because of the fact that property and payroll costs were lower abroad that the combined group was able to realize greater profits in Example 3. Logically, one would expect that the taxable profits of the foreign company would be greater than those of the California company, based on equivalent sales, since the costs abroad are markedly lower than the costs in California. This is plainly not the case, when the formula approach is used. Instead of recognizing the lower cost patterns abroad and the greater profitability of foreign companies, the formula overstates the portion of profit attributable to California and understates it to the foreign country.

E. The Supremacy Clause.

Unquestionably, the preferred method for allocating profits and income earned across international borders is that of "arm's length" separate accounting. Indeed, "arm's length" separate accounting is almost unanimous in its use by the foreign economies in the Free World. It has been referred to as the "internationally accepted norm"[2] and it underlies the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development ("OECD").[3] The "arm's length" method appears in the first income tax convention to which the United States was a party (Income Tax Convention, April 27, 1932, United States-France, Article IV, 49 Stat. 3145, TS No. 885) and

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[2]"*Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:*" *Hearings before the Senate Comm. on Foreign Relations, 95th Cong.*, 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[3]Article 7, Sec. 2; Article 9, Sec. 1.

it has been the basis for all tax treaties ratified since by the federal government.[4]

In its January, 1979 report entitled "Transfer Pricing and Multinational Enterprises" (which was subsequently adopted by the Council of the OECD in May, 1979), the Fiscal Affairs Committee of OECD roundly condemned so-called "global" methods of profit allocation, such as worldwide formulary apportionment, in favor of the "arm's length" principle. The report stated:

> "Proposals for radical reformulations of the approach to intragroup transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, *are not endorsed* in this report. *The use of such alternatives to the arm's length principle is incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention*. . . .
>
> Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their uncoordinated use by the tax authorities of several countries would involve the danger that, overall, the [multinational enterprise] affected would suffer double taxation of its profits." [*"Transfer Pricing and Multinational Enterprises," Report of the OECD Committee on Fiscal Affairs* (Paris, 1979), pp. 14 & 15] Emphasis supplied.

The widespread consensus in favor of the arm's length method is indicated by the following extract from the same report:

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[4]Cf. U.S.-France, 7/25/39, Art. 3, 125 UNTS 259; U.S.-New Zealand, 3/16/48, Art. 3, Par. 1, 2 UST 2378; U.S.-Pakistan, 7/1/57, Art. 3, Par. 2, 10 UST 984.

> ". . . it may be noted that the arm's length approach, which underlies this report, has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries, and that there is a broad consensus among governments of developed and developing countries and [multinational enterprises] that arm's length pricing is an appropriate approach to adopt in arriving at profits for tax purposes." [*"Transfer Pricing and Multinational Enterprises,"* pp. 8 & 9]

Senator Howard H. Baker, Jr. (R., Tennessee) aptly noted the potentially adverse ramifications, at the international level, should any state of the United States be permitted to use worldwide formulary apportionment, in views expressed in a Senate Committee Report on the proposed 1975 Income Tax Convention between Great Britain and the United States:

> "The precedent of unitary taxation on a worldwide combined reporting basis cannot be established by this country without probable retaliation by scores of countries around the world whose ambition may extend to those profits of U. S. multinational corporations generated beyond their jurisdictional limits." [Report of the Committee on Foreign Relations of the United States Senate (Ex. Rpt. 96-5, June 15, 1979), p. 16.]

Precisely this same concern was articulated by this Court in *Japan Line*, in addressing the impact which a novel state tax could have at the international level:

> "If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole

would suffer." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S., at page 450.[5]

In testimony before the United States Senate Foreign Relations Committee in July, 1977, former Assistant Secretary of the Treasury Laurence N. Woodworth stated that the formulary apportionment method in an international context generates complaints from treaty signatories, varies from the internationally accepted arm's length practice and carries with it the potential for extraterritorial taxation.[6]

Were the State of California permitted to use its formulary apportionment method as against a tax base consisting of the *pretax incomes* of appellant and its foreign subsidiaries it would impact negatively on the foreign economic policies of the United States in yet another respect.

In this respect it was the express policy of the United States Government during the period in issue (roughly 1963 through 1965) to promote, through foreign investment, the economic growth and industrial development of the undrveloped and underdeveloped areas of the Free World. This

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[5]There is and can be, of course, no direct relationship between a state of the United States and a foreign corporation having no nexus or contact with the state, or between the state and a foreign taxing authority. Hence, foreign corporations in which a U.S. corporation has invested have no protection against the arbitrary levy of corporate income tax by a state under the unitary tax method or any other method. [Blough and Wagner, "U.S. Income Tax Treaty with the United Kingdom: Evaluation of Its Benefits to the United States Including Reasons for Approving the Constraints It Places on State Use of Unitary Apportionment", U.S. Department of Commerce: Foreign Business Practice Division-Office of International Finance and Investment Industry and Trade Administration (April 19, 1979), page 16.]

[6][*"Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:" Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Sess., page 33 (1977)*]

policy was reflected not only in various federal statutes[7] but in treaties[8] as well.

Appellee insists that California does not impose a direct tax upon the incomes of foreign based corporations. The practical effect, however, of including the incomes of appellant's foreign subsidiaries in its apportionable base clearly taxes such profits. As noted by Mr. Woodworth at the 1977 Congressional hearings considering the proposed United States/United Kingdom Treaty:

> "Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. *Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tan-*

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[7]In the *Foreign Assistance Act of 1961*, the United States Congress declared it to be the official policy of the United States to:

> "(1) . . . encourage the efforts of other countries to increase the flow of international trade, to foster private initiative and competition, . . .; and *to encourage the contribution of United States enterprise towards economic strength of less developed friendly countries, through private trade and investment abroad,* . . ." [75 Stats. 424, 22 *U.S.C.* §2351] Emphasis supplied.

[8]During the period in issue there were in force and effect a number of "investment guarantee" treaties [cf: U.S.-Argentina 12/5/61, 12 U.S.T. 955; U.S.-Italy 10/18/57, 8 U.S.T. 1881; U.S.-Mexico 4/6/54, 5 U.S.T. 1373] pursuant to 22 *U.S.C.* §2181 as well as "Technical Cooperation" treaties pursuant to 22 *U.S.C.* §2161 between the United States and developing nations. Typical of the former group is the treaty between the United States and Argentina entitled "Guaranty of Private Investment", which provides:

> "Recognizing that the investment in Argentina of private capital originating in the United States of America can stimulate the economy of Argentina, thereby effecting a rise in its production and a greater exchange in trade between the Argentine Republic and the United States of America; [the United States agrees to confer regarding investment guarantees]."

tamount to taxation by a state government of the foreign income of a foreign corporation."[9]

Imposition by the State of California of an increased incidence of tax on a United States corporation by reason of its having invested in foreign subsidiaries doing business in underdeveloped areas of the Free World clearly discourages such foreign investment by United States corporations, interferes with established national policy, and unconstitutionally intrudes upon the federal power to deal with foreign affairs. By subjecting appellant to an increased tax liability as a result of its investments in foreign companies, the State of California creates a substantial disincentive to further investment abroad. Mr. Woodworth recognized the inhibitive effect which taxes have on the free flow of capital and technology to foreign countries when he stated:

> ". . . among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries.
>
> ". . . one of our fundamental objectives is to minimize impediments to free international flows of capital and technology[.] . . ."[10]

Under the federal constitution responsibility for the conduct of national foreign policy is entrusted solely to the federal government [*U.S.* Const. Art. II §3; *Zschernig v. Miller*, 389 U.S. 429, 443, 19 L.Ed.2d 683, 693 (1968)] as is the treaty-making power [*U.S.* Const. Art. II §2 Clause 2]. Under the Supremacy Clause [*U.S.* Const. Art. VI clause

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[9] "*Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:*" *Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Session p. 34 (1977) emphasis supplied.*

[10] "*Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines:*" *Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Session p. 28 (1977).*

2] the power of the federal government over foreign policy is exclusive, plenary, and not subject to interference or curtailment by the states. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 315, 81 L.Ed. 255, 260-261 (1936); *United States v. Belmont*, 301 U.S. 324, 330, 81 L.Ed. 1134 (1937). Issues relating to the expansion or contraction of foreign trade and the degree to which the United States and its citizens will assist in the development of industry abroad are policies that are national in scope and must be left to the federal government. Assertion of the California formulary method in the area of foreign economic policy has clear potential for disruption and is an obvious unconstitutional intrusion into this exclusive federal domain.

Conclusion.

Apportionment by formula of the combined incomes of a United States parent corporation and foreign subsidiaries incorporated and doing business exclusively abroad, on a worldwide combined report basis, contravenes both the Commerce Clause and the Supremacy Clause of the federal constitution. In addition, where as here the record has shown that such formulary method grossly distorts the attribution of income for state tax purposes, the Due Process Clause is likewise violated. Because of this, the judgment of the California Court of Appeal upholding the application of a three-factor apportionment formula to a tax base consisting

of the incomes of appellant Container Corporation of America and its majority-owned foreign subsidiaries must be reversed.

Dated: July 29, 1982.

Respectfully submitted,

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No. 81-523

In The

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal From the Court of Appeal
of the State of California
for the First Appellate District

BRIEF FOR GULF OIL CORPORATION AS AMICUS CURIAE IN SUPPORT OF APPELLANT

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TABLE OF CONTENTS

PAGE

Statement of Interest 1

Summary of Argument 3

Argument 6

I. The Rationale Of Combined Report/Formula Apportionment Does Not Apply To Foreign Operations Of Multinational Enterprises 6

A. Economic Disparities 8

B. Disparity in Taxing Conditions 11

II. This Court's Holding in *Japan Line, Ltd.* Prohibits State Taxation of Foreign Commerce When It Prevents the Federal Government From Speaking with "One Voice" or Creates a Risk of Multiple Taxation 14

III. Multinational Trade Clearly Constitutes an Area in Which the Federal Government Must Speak With "One Voice" and in Which It Has So Spoken Through a Network of Tax Treaties 15

IV. Worldwide Unitary Treatment Inevitably Results in Double Taxation 17

Conclusion 20

TABLE OF AUTHORITIES

CASES	PAGE
Adams Exp. Co. v. Ohio State Auditor, 166 U.S. 185 (1897)	6
Bass, Ratcliff & Gretton v. State Tax Commission, 226 U.S. 271 (1924)	14
Butler Bros. v. McColgan, 315 U.S. 501 (1941)	6
Evco v. Jones, 409 U.S. 91 (1972)	19
Gulf Oil Corporation, et al. v. The Franchise Tax Board of the State of California, Superior Court of The State of California for the County of San Diego, No. 414285	2
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	4, 14
J.D. Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938)	19
Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980)	14
Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920)	6
UNITED STATES CONSTITUTION	
Foreign Commerce Clause Article I, Section 8, Clause 3	*passim*
OTHER AUTHORITIES	
1 CCH, Tax Treaties, §§ 151, 153	16
1917 Nat. Tax Ass'n. Proceedings 185, at 194	6
Organization for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977), Articles 7 and 9	16
Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979)	16
"Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business, 1922 Nat. Tax Ass'n. Proceedings 198, at 201	6

CASES — PAGE

Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report 16

Staff Policy Report of the Advisory Commission on Intergovernmental Relations, "State Taxation of Multinational and Multistate Corporations" (9/4/81) 15

Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 Law and Policy in International Business 409, 415, 416 (1978) (The International Journal of Georgetown University Law Center) 7

United States Treasury Department's Model Income Tax Treaty of May 17, 1977, Articles 7 and 9 16

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BRIEF FOR GULF OIL CORPORATION AS AMICUS CURIAE IN SUPPORT OF APPELLANT

STATEMENT OF INTEREST

This Brief is submitted with the written consent of the parties on file with the Clerk of this Court.

Gulf Oil Corporation ("Gulf") and most of its subsidiaries are engaged in the petroleum business in the United States and other countries of the world. Its primary oil production has

been in Kuwait, Iran, Nigeria, Ecuador, Venezuela, and Angola. These countries are hereinafter referred to as the "KINEVA" countries (an acronym composed of the first letter of each name).

Because of the substantial effect of state income taxation upon its business activities, Gulf has a special interest in this case which presents issues significantly affecting state taxation of foreign commerce.

Gulf currently is challenging in several states at the administrative level the propriety of the formula apportionment method as applied on a worldwide basis. Gulf recently litigated the issue with respect to the years 1966-1974 in a California trial court.[1]

Under the combined report/formula apportionment method of income taxation (simplistically referred to by some commentators as the "unitary approach," "unitary apportionment approach," or by similar terms), Gulf's state income tax liability is determined by combining the worldwide income (without deducting domestic or foreign income taxes) of Gulf and its worldwide subsidiaries, which income then is attributed to a particular state under the so-called "three-factor formula" apportionment method, *i.e.*, on the basis of the relative amounts of property, payroll, and sales in the state, as compared to the total worldwide property, payroll, and sales of the combined group.

Gulf is not contesting the propriety of the combined report/formula apportionment method as applied to income from operations conducted within the United States. However, it does contend that the determination of the amount of income earned from operations within the United States should be made under the internationally accepted arm's length method.

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[1] *Gulf Oil Corporation, et al. v. The Franchise Tax Board of the State of California,* Superior Court of the State of California for the County of San Diego, No. 414285. The case, which also involved other issues, was favorably settled to Gulf near the conclusion of Gulf's case in chief.

The determination of what constitutes foreign income should be made in the same way. The concept of applying the combined report/formula apportionment method to income from operations conducted within the boundaries of the United States (*i.e.*, the "water's edge"), but applying the arm's length method to determine that amount of the United States income, is commonly referred to as the "water's edge" rule.

Gulf's concern here is to alert this Court to the overwhelming disparity between economic and taxing conditions in other countries of the world, such as in the KINEVA countries, as compared to those in the United States, and thus to demonstrate the inequity resulting from the application, by the State of California or any other state, of the combined report/formula apportionment method to income from operations beyond the "water's edge."

SUMMARY OF ARGUMENT

The combined report/formula apportionment method of income taxation originated as a judicially created concept which was borrowed from property tax cases as an expedient, albeit rough, method of dividing profits among the various states of the United States. It has been developed and nurtured in the context of operations within the United States, where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably comparable, and where currency values are the same.

Fundamental to the rationale of the method is the assumption that all states within the United States are reasonably homogeneous in terms of economic and taxing conditions. On a worldwide basis, a similar assumption is simply not true, and the method thereby becomes inequitable and distortive when extended to the nonhomogeneous world. Generally, the formula apportionment method has been applied throughout the years to single enterprises only. A few states, such as California and Illinois, are now attempting to apply the method on a combined basis to multiple enterprises.

The great differences between the economic and taxing conditions in other parts of the world as compared to those in the United States are vividly demonstrated by the following facts, which reflect comparisons between the KINEVA countries and California in the years 1971-1974:[2]

(1) Payroll costs in California per dollar of oil output were from 15 to 40 times higher than the comparable costs in the KINEVA countries.

(2) Property costs in California per dollar of oil output were from 16 to 30 times higher than the comparable costs in the KINEVA countries.

(3) Average daily output per oil well in the KINEVA countries ranged from 294 to 358 times that in California.

(4) Income tax rates in the KINEVA countries, when considered under California concepts of taxable income, ranged from 96% to 107% (as compared to the United States rate approximating 48%).

(5) The excess of income taxes paid to the KINEVA countries over what the Gulf group would have paid had the same income been earned in the United States ranged from $697 million to $2.488 billion per year.

In *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), this Court determined that, when testing a tax under the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3), two requirements must be met, over and above those applicable under the Interstate Commerce Clause. First, the tax must not create a "substantial risk of international multiple taxation," and, second, the tax cannot prevent the Federal government from "speaking with one voice when regulating commercial relations with foreign governments."

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[2] The facts set forth herein are based upon the evidence introduced by Gulf in the California litigation referred to in fn. 1. The years 1971-1974 were the last four years involved in that litigation.

Both of these requirements would be violated if a state were permitted to extend the combined report/formula apportionment method to foreign operations of multinational enterprises, whether they be foreign or domestically owned. Foreign commerce is preeminently a matter of national concern. In such matters, the Government must speak with one voice, and notwithstanding apportionment the tax must not create a substantial risk of international multiple taxation.

Most of the non-Communist major countries of the world, including the United States, have entered into an extensive network of treaties covering the avoidance of double taxation of income, and the touchstone of taxation under all of these treaties is the arm's length method, *viz.*, the "water's edge" rule.

To the extent that any state within the United States applies the combined report/formula apportionment method on a worldwide basis, it attributes to that state a certain portion of income which has already been taxed under the internationally accepted arm's length method by a foreign country, *e.g.*, each of the KINEVA countries. Since the foreign country has already taxed 100% of that income, the imposition by a state of a tax on a portion of that same income subjects that income to double taxation.

Obviously, since the foreign country uses arm's length principles, no correlative adjustments will be made by the foreign country by reason of the attribution of income to the state imposing the combined report/formula apportionment method, and the United States courts have no power to relieve that inequity. Under such circumstances, multiple taxation inevitably results.

The problem of double taxation becomes particularly acute by reason of the fact that economic and taxing conditions throughout the world are substantially disparate from those existing in the United States. No formula method could possibly be workable unless an authoritative tribunal existed to remedy multiple or unjust taxation.

ARGUMENT

I

The Rationale Of Combined Report/Formula Apportionment Does Not Apply To Foreign Operations Of Multinational Enterprises.

The concept of formula apportionment originated as a judicially created concept which was borrowed from the property tax cases as an expedient, albeit rough, method of dividing the total profits of an enterprise, for income tax purposes, among the various states in which the enterprise operates.[3] A primary element in the development of formula apportionment within the United States has been a quest for uniformity and comity among the states, rather than mathematical precision.[4] The rationale of formula apportionment is that each dollar of property, payroll, and sales produces an equal amount of income. Obviously, this rationale assumes at least roughly comparable economic and taxing conditions in the various taxing jurisdictions. While such comparability may reasonably exist among the states of the United States, it does not exist on a

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[3] *See, e.g., Adams Exp. Co. v. Ohio State Auditor,* 166 U.S. 185 (1897). *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920); *Butler Bros. v. McColgan,* 315 U.S. 501 (1941).

[4] This was early recognized by Professor T. S. Adams of Yale, one of the early pioneers on the subject, who declared in 1917 to the National Tax Association:

> "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdictions."

1917 Nat. Tax Ass'n. Proceedings 185, at 194. A Committee of the National Tax Association, echoing Dr. Adams' views, put the matter thus in 1922:

> "All methods of apportionment of trading profits are arbitrary. . . . [T]here is no one right rule of apportionment. . .[T]he only right rule . . . is a rule on which the several states can and will get together as a matter of comity."

"Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business," 1922 Nat. Tax Ass'n. Proceedings 198, at 201.

worldwide basis,[5] as shown by the actual facts of the Gulf group. Therefore, the basic assumption underlying the combined report/formula apportionment method; namely, that each dollar of payroll or property, as the case may be, produces a roughly equivalent amount of income in each of the jurisdictions in which a taxpayer operates, becomes fallacious when applied on a worldwide basis.

The tremendous disparities between economic and taxing conditions elsewhere in the world, such as in the KINEVA countries, and those in the United States, are vividly demonstrated by the following Gulf facts, based upon the years 1971 through 1974:[6]

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[5] In addition, formula apportionment mechanically divides overall profits based on deemed economic activity without regard to the realities of the marketplace. The arm's length method tracks the marketplace where profits or losses do not conform to a simplistic formula, and market conditions are substantially more diverse on a worldwide basis than within the United States. See, Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 Law and Policy in International Business, 409, 415 (1978) (The International Journal of Georgetown University Law Center).

[6] See fn. 2.

A. Economic Disparities

1. *Productivity Per Dollar of Payroll*

Table 1 below shows the differences in payroll costs per dollar of output in California as compared to the KINEVA countries:

Table 1

Payroll Cost Per $ of Output 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	$ .122	$ .003	40:1
1973	.252	.012	21:1
1972	.276	.018	15:1
1971	.255	.016	16:1

Thus, a dollar of payroll in the KINEVA countries produced from 15 to 40 times as much revenue as a dollar of payroll in California.

2. *Productivity Per Dollar of Property*

Table 2 shows the differences in property costs per dollar of output in California as compared to the KINEVA countries:

Table 2

Property Cost Per $ of Output 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	$ 4.683	$ .150	31:1
1973	11.843	.435	27:1
1972	12.028	.725	16:1
1971	11.219	.708	16:1

Accordingly, a dollar of property in the KINEVA countries produced from 16 to 31 times as much revenue as a dollar of property in California.

3. *Productivity Per Oil Well*

Table 3 below shows the differences between California and the KINEVA countries in average daily output per oil well:

Table 3

Average Daily Output Per Well (barrels per day) 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	22	7880	1:358
1973	21	7510	1:357
1972	24	7430	1:309
1971	24	7070	1:294

It is apparent from the above figures that the basic economic conditions in the KINEVA countries are dramatically different from those in California. An oil well in the KINEVA countries was about 300 times as productive as an oil well in California.

B. Disparity in Taxing Conditions

Table 4 below shows the KINEVA income tax burden imposed upon the Gulf group based upon KINEVA pre-tax income (calculated in the same manner as California computes taxable income):

Table 4

KINEVA Income Tax Burden
1971-1974
($ in Millions)

	(1) KINEVA Pre-Tax Income California Basis	(2) KINEVA Income Taxes	(3) Income After KINEVA Taxes	(4) KINEVA Tax Rate
1974	$2,317.7	$2,488.1	$(170.4)	107%
1973	1,322.8	1,283.7	49.1	96%
1972	781.9	774.2	7.7	99%
1971	732.3	714.1	18.2	97%

The effective KINEVA tax rates, based upon California concepts of taxable income, ranged from 96% to 107%. Yet, California imposed its tax upon the pre-tax income shown in Column (1) of Table 4 by application of the combined report/formula apportionment method. California allowed neither a credit nor a deduction for these foreign income taxes shown above.

Had the KINEVA operations of the Gulf group been conducted in the United States rather than in KINEVA, the income tax burden, to yield the same amount of after-tax income to the Gulf group, would have been dramatically less, as demonstrated in Table 5 below.

Table 5

KINEVA Income Tax Burden
As Contrasted to
Comparable U.S. Income Tax Burden
1971-1974
($ in Millions)

	(1) KINEVA Income Taxes	(2) Comparable U.S. Income Tax Burden[7]	(3) Excess of (1) over (2)
1974	$2,488.1	$ -0-	$2,488.1
1973	1,283.7	45.3	1,238.4
1972	744.2	7.1	767.1
1971	714.1	16.8	697.3

The Gulf group's KINEVA income taxes exceeded the taxes which would have been paid to the United States, had that income been earned in the United States, by amounts ranging from $697 million to $2.488 billion per year. Thus, the income taken into account by California in applying the combined report/formula apportionment method is overstated by the same excess amounts shown in column (3) of Table 5. This obviously penalizes the Gulf group for operating in KINEVA rather than in the United States.

A corporation operating in California or elsewhere in the United States would have paid a Federal income tax in the range of 48%, leaving it with 52% of each dollar of taxable income in its pocket. In the KINEVA countries, however, the Gulf group paid income taxes (under California concepts of taxable income) at effective rates ranging upward from 96%, thus leaving it with 4% or less of each dollar of taxable income in its pocket. In the case of the Gulf group these excess taxes were enormous, *i.e.*, up to $2.488 billion per year. California imposed its tax on its attributed share of these excess taxes.

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[7] Derived by "grossing up" the KINEVA after-tax income shown in column (3) of Table 4 to what would be the U.S. pre-tax income required to produce such after-tax income. The income shown in said column (3) is divided by the assumed U.S. after-tax income, *i.e.*, 52% (based upon an assumed tax rate of 48%), to arrive at said "grossed-up" income.

The inequity of the combined report/formula apportionment method under these diverse world taxing conditions is obvious. While, companies operating within the United States incur the same level of Federal taxation, the Gulf group, because it operated in the KINEVA countries, was taxed by California on a much higher level of taxable income.

As is apparent from the above comparisons between economic and taxing conditions in the KINEVA countries and those in California, the combined report/formula apportionment method is ill-adapted for worldwide use. The formula apportionment method was developed and has been nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably homogeneous, and where the currency is the same. On a worldwide basis, however, the rationale of formula apportionment becomes inapplicable.

There are wide ranges in wage rates and productivity of labor in different areas of the world; substantial differences exist in costs and productivity of plant, equipment, and other property; risk factors and rates of return are different, currencies are different, and conversion rates fluctuate. Taxing patterns also differ, and, as pointed out, California and many other states give neither a credit nor a deduction for foreign income taxes. This distorts the product of the formula apportionment method because the income base against which the formula is measured is not comparable to a base derived from United States operations.

World conditions simply are far more diverse than conditions in the states of the United States, and these differences are much too common and far too significant and complex to be accommodated on some *ad hoc* basis by modification of an apportionment formula. The formula method is intended as a rule of virtually universal application, and it simply becomes irrational and arbitrary in the worldwide context. Whatever the shortcomings of the arm's length method may be, they surely

are not sufficient to warrant the imposition of the formula method which has lost its rational underpinnings in the context of diverse world conditions.

II

This Court's Holding in *Japan Line, Ltd.* Prohibits State Taxation of Foreign Commerce When It Prevents the Federal Government From Speaking with "One Voice" or Creates a Risk of Multiple Taxation.

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), this Court set forth the governing principles which apply when testing a tax on instrumentalities of foreign commerce under the Foreign Commerce Clause, which are over and above those applicable under the Interstate Commerce Clause. First, the tax must not create a "substantial risk of international multiple taxation."[8] Second, the tax cannot prevent the Federal government from "speaking with one voice when regulating commercial relations with foreign governments."[9] "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause."[10]

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[8] 441 U.S. at 451.

[9] *Id.*

[10] *Id.* Although this Court declined to apply the *Japan Line* rationale in *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), which involved an income tax, the *Mobil* situation was correctly analyzed by this Court as involving only issues of interstate commerce, not foreign commerce, since Mobil conceded that the dividend income in question could be taxed by the State of New York. Moreover, *Mobil* involved only the issue of multiple taxation, and not the issue that the Nation must speak with "one voice."

This Court's decision in *Bass, Ratcliff & Gretton v. State Tax Commission*, 226 U.S. 271 (1924), which upheld formula apportionment (not combined reporting) as to a foreign corporation operating directly within the United States, involved, insofar as the Foreign Commerce Clause was concerned, only the limited issue of whether the tax constituted a direct tax on foreign commerce. Further, the record, both factually and legally, was so incomplete as to leave this Court with no logical basis for rejecting the formula concept. Moreover, international economic, trade, and tax relationships today can hardly be compared to those which existed in 1918 (the fiscal year in issue), over 60 years ago.

Both of the above precepts would be violated if a state were permitted to extend the combined report/formula apportionment to foreign income of multinational enterprises, *viz.*, beyond the "water's edge."

III

Multinational Trade Clearly Constitutes an Area in Which the Federal Government Must Speak With "One Voice" and in Which It Has So Spoken Through a Network of Tax Treaties.

"Foreign commerce is preeminently a matter of national concern,"[11] and the Federal Government must speak with "one voice." Multinational trade must be governed by internationally accepted principles of taxation, not by peculiar taxing concepts of individual nations, and certainly not by those of states or other political subdivisions of nations. There is no question but that the "arm's length" method, not formula apportionment, is the internationally accepted rule for the taxation of multinational trade. The United States and most of the major non-Communist countries of the world have established tax principles which govern multinational trade relationships through an extensive network of tax treaties. These tax treaties universally embrace the "arm's length" method to separate foreign income from United States income. The concept of formula apportionment is prohibited under these treaties with respect to transactions between treaty nationals. Formula apportionment is thus prohibited beyond the territorial boundaries of the United States, *viz.*, the "water's edge" rule.[12]

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[11] *Ibid.*, fn. 8, at 448.

[12] See, Staff Policy Report of the Advisory Commission on Intergovernmental Relations, published as a separate report entitled "State Taxation of Multinational and Multistate Corporations" (9/4/81), at p. 9.

The Advisory Commission on Intergovernmental Relations is the permanent commission established by Congress in 1959 to monitor intergovernmental relations and to make recommendations for change. Members include federal, state and local elected and appointed officials and private citizens.

(Footnote continued on following page)

Moreover, formula apportionment in multinational transactions has been repudiated by various world organizations, such as the Organization for Economic Co-operation and Development and the United Nations.[13]

The adverse reaction of foreign nations to the proposed application of the combined report/formula apportionment method to multinational operations of foreign-owned affiliated groups has been vehement. A number of foreign governments have lodged formal letters of protest with the United States Government.[14] While it is true that foreign governments are primarily concerned with groups owned by their own corporate nationals, the interpretation of the Foreign Commerce Clause should not depend upon whether the multinational group is foreign owned or domestically owned. It would be incongruous to construe the Foreign Commerce Clause so as to discriminate against domestically owned multinational groups by imposing the combined report/formula apportionment method on such domestic groups but not on foreign owned groups.

(Footnote continued from preceding page)

See also, Articles 7 and 9 of both the Organization for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977), and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977, reprinted at 1 CCH, Tax Treaties, § 151, 153.

[13] Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report; Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979).

[14] *Ibid.*, fn. 12, at 11.

IV

Worldwide Unitary Treatment Inevitably Results in Double Taxation.

There can be no doubt that the combined report/formula apportionment method, when applied on a worldwide basis, creates more than the risk of multiple taxation; it produces multiple taxation in fact. All of the income earned abroad is taxed under internationally accepted arm's length principles, without any apportionment. To the extent that any state utilizes worldwide combined report/formula apportionment, it attributes to that state a certain portion, as determined by the formula, of the income which has already been taxed 100% by a foreign country. Thus, the taxation by a state of a portion of that same income in fact imposes an impermissible multiple tax burden on that income.

Obviously, since the foreign country uses arm's length principles, no correlative adjustments will be made by the foreign country by reason of the attribution of income to the state imposing the combined report/formula apportionment method, and the United States courts have no power to relieve that inequity. Under such circumstances, "multiple taxation inevitably results."[15]

If all the states had approximately equal tax rates and applied the formula method uniformly (which they do not), proper tax harmonization would occur in the case of a taxpayer operating wholly within the United States, inasmuch as that taxpayer would be taxed only once at the state level (and only once at the Federal level). On a worldwide basis no such harmonization is possible.

It is no answer to say that no double taxation occurs because the United States Government allows a credit against Federal income taxes for foreign income taxes paid. In the first place, this credit is a feature of Federal tax policy to alleviate

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[15] *Ibid.*, fn. 8, at 447.

double taxation at the Federal level. It is not a license for states such as California to impose a double tax burden on multinational taxpayers at the expense of the Federal Government. Secondly, the amount of the Federal credit is limited to the rate of Federal taxation, computed on income determined under United States principles of taxation, and in the case of Gulf, for example, the foreign tax burdens in the KINEVA countries vastly exceeded the amount of tax credits available against United States income taxes.

It is also no answer to argue that there otherwise is no absolute symmetry between the taxing systems of the United States and those of many foreign countries, and thus there always may be some double taxation. The fact that tax symmetry is not otherwise perfect throughout the world does not justify the imposition by the State of California of an additional inequitable double tax burden on multinational taxpayers.

It is likewise invalid to argue that there is no double tax burden as to countries which levy taxes only at the national level rather than both at the national level and at the local level. Whether or not a particular country is structured with a type of political subdivision such as we have in the United States, and whether or not a particular country may choose to fund its governmental operations solely through national taxes rather than a combination of national and local taxes, is purely a function of the political infrastructure of the particular foreign country, and is irrelevant to the double taxation issue.

Moreover, even "[i]f the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise," and "notwithstanding apportionment . . . [the tax must not create] a substantial risk of international multiple taxation."[16]

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[16] *Ibid.*, fn. 8, at 450-51.

"Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' "[17]

This necessity for an international "authoritative tribunal" is acute with respect to worldwide formula apportionment because of the tremendous disparity between economic and taxing conditions abroad and those in the United States, and international conformity on the issue of allocation of income is critical "if there is to be order and rationality in the tax relationships among nations."[18]

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[17] *Ibid.*, fn. 8, at 447-48, citing *Evco v. Jones*, 409 U.S. 91 (1972), at 94, quoting *J. D. Adams Mfg. Co.*, 304 U.S. 307 (1938), at 311.

[18] In any event, the formula apportionment method, "when applied to an enterprise touching two or more countries requires some international authority or arrangement to be operable, and hence at least on a short-range horizon does not seem feasible." Surrey, *op. cit.* fn. 5, at pp. 409, 416.

CONCLUSION

The combined report/formula method was created and has been nurtured in the United States, where the economic and commercial environment in the various states is reasonably comparable. World conditions can be tremendously disparate. The arm's length method is the touchstone of international tax relationships and harmonization, and double taxation would "inevitably result" if the formula concept were applied to income from foreign business operations. Accordingly, the combined report/formula method should not be extended beyond the "water's edge."

Respectfully submitted,

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No. 81-523

IN THE SUPREME COURT
OF THE
UNITED STATES

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,
vs.
FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal
of the State of California
for the First Appellate District

BRIEF OF AMICUS CURIAE STATES OF IDAHO AND UTAH

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TABLE OF CONTENTS

	Page
Statement of Interest	1
Summary of Argument	5
Argument	8
Conclusion	23

INDEX OF AUTHORITIES

Cases Page

ASARCO, Inc. v. Idaho State Tax Commission, ___ U.S. ___, 50 USLW 4962, Dk #80-2015 decided June 29, 1982. . . . 2, 21

Albany International Corporation v. Halperin, (Maine) 388 A.2d 902 (1978). 18

Bass, Ratcliff & Gretton Ltd. v. State Tax Commission, 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82 (1924) 12

Coca-Cola v. Department of Revenue (Oregon), 553 P.2d 778 (1975). . 11

Edison California Stores v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947). 11

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 65 L.E.2d 66, 100 S.Ct. 2109 (1980) 6, 7, 21

F. W. Woolworth Co. v. Taxation and Revenue Department, 50 Law Week 4957 21

General Motors Corp. v. District of Columbia, 380 U.S. 553, 14 L.Ed.2d 68, 85 S.Ct. 1156 (1965).) 15

Page

Gulf Oil Corp. v. Morrison, 120 Vt. 324, 141 A.2d 671 (1958) 20

Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980) . . . 8, 10, 11, 12, 21, 22

Moorman Mfg. Co. v. Bair, 437 U.S. 267, 57 L.Ed.2d 197, 98 S.Ct. 2340 (1978) 8, 19

National Geographic Society v. California Board of Equalization, 430 U.S. 551, 51 L.Ed.2d 631, 97 S.Ct. 1386 (1977) 14

Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 3 L.Ed.2d 421, 79 S.Ct. 357 (1959) 14, 20

Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169, 93 L.Ed. 585, 69 S.Ct. 432 (1948), reh.den. 336 U.S. 928, 93 L.Ed. 1089, 69 S.Ct. 653 (1949) 9, 23

Roger Dean Enterprises, Inc.v. State, (Florida) 387 S.2d 358 (1980) . 19

W.R. Grace & Co. v. Commissioner of Revenue (Massachusetts) 393 N.E.2d 330 (1979) 20

Page

Wisconsin v. J.C. Penney Co., 311 U.S. 435, 85 L.Ed. 267, 61 S.Ct. 246 (1940) 9, 10, 13, 23

Xerox v. Comptroller of Treasury (Maryland), 428 A.2d 1208 (1981) 20

Zale-Salem, Inc. v. State Tax Commission (Oregon), 391 P.2d 601 (1964) 11

Other Authorities

GAO Report to the Chairman of the House Committee on Ways and Means GGD-81-81, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (Sept. 30, 1981) 4

Tax Notes, July 5, 1982.). . . . 16, 20

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BRIEF OF AMICUS CURIAE STATES OF IDAHO AND UTAH

STATEMENT OF INTEREST

The taxpayer in this case,

Container Corporation of America (hereinafter "CCA"), challenges the right of the State of California to use the combined reporting method of determining net income of a multi-jurisdictional corporation subject to California's franchise tax. The taxpayer contends, in part, that requiring a combined report of income violates the due process requirements of the Fourteenth Amendment to the U. S. Constitution.

The States of Idaho and Utah use--and have used for many years--combined reporting for groups of commonly owned corporations who conduct unitary business operations in interstate or international commerce. See e.g. ASARCO, Inc. v. Idaho State Tax Commission, ___ U.S. ___, 50 USLW

4962, Dk #80-2015 decided June 29, 1982. A growing number of states have recognized the validity of the unitary concept and are now applying the unitary method of reporting.

Combined reporting is a practical necessity in a nation and world where corporate activities and combinations know few, if any, economic boundaries. Without it, corporate taxpayers would be free to shift income among commonly controlled corporations dealing at less than arms length, thereby artificially reducing tax responsibilities to the states in which they do business. The only possible state response is to attempt to make transactional adjustments on a transaction by transaction basis to ensure they reflect a true arms length

relationship. Section 482 of the Internal Revenue Code allows the IRS to make such adjustments. However, federal experience amply demonstrates that the method is almost impossible to apply on the federal level. See, GAO Report to the Chairman of the House Committee on Ways and Means GGD-81-81, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (Sept. 30, 1981). Without a method of combined reporting, it would be totally impossible for states concerned about interstate as well as international commerce.

As an amicus curiae, the States of Idaho and Utah have a vital interest in protecting the authority of all states to use the combined reporting

method of attributing income for state tax purposes. We believe it to be fair, practical and constitutional.

SUMMARY OF ARGUMENT

A taxpayer who attacks a state income or franchise tax assessment under the Due Process Clause must show by clear and cogent evidence that (a) there is no minimal connection between the activities taxed and the taxing state or (b) that there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise. CCA has not made that showing.

There is no question that CCA possesses the requisite nexus with California. The issue is whether the amount of income attributed to California is rationally related to

the amount of income-producing activity conducted there. When a group of commonly owned and controlled corporations conducts a functionally integrated business, application of the standard three factor formula to the combined apportionable income of the corporations automatically meets this second due process requirement.

When a group of corporations conducts a unitary business--such that the activities of each contribute to or are dependent upon the activities of one or more other corporations in the group--it is not reasonably possible to specifically or separately account for the income of each on a state by state basis. When a single corporation conducts such a unitary business, this Court has always

recognized that attributing income on the basis of the location of income-producing activities determined by the location of property, payroll and sales is reasonable and constitutional. See e.g., Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980). There is no constitutional or logical reason for this concept to apply differently if the same business activities are conducted by means of separately incorporated subsidiaries rather than by divisions of one parent. If, as this Court has held in Exxon, supra, a single unitary business conducted by one corporation can have its income attributed by apportionment formula without viclating the Due Process Clause, there is no due process bar to

apportioning the similar income of a unitary business conducted by a controlled group of corporations. The underlying income-producing activities--which are the justification for the apportionment in the first place--are unchanged by the creation of a legal fiction--i.e., subsidiary corporation.

ARGUMENT

State taxation of income generated by a business engaged in interstate or foreign commerce must meet two requirements to satisfy the due process clause of the Fourteenth Amendment. These requirements are that: (1) a "minimal connection" or nexus must exist between the interstate activities and the taxing state, and (2) there must be a

rational relationship between the income attributed to the state and the intrastate values of the enterprise. Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980); Moorman Mfg. Co. v. Bair, 437 U.S. 267, 57 L.Ed.2d 197, 98 S.Ct. 2340 (1978).

A less formal statement of the test, but one which fully captures the substance of the questions involved, was set forth by this Court in Wisconsin v. J.C. Penney Co., 311 U.S. 435, 85 L.Ed. 267, 61 S.Ct. 246 (1940):

> That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.

This statement was made even more succinctly in Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169, 93 L.Ed. 585, 69 S.Ct. 432 (1948), reh.den. 336 U.S. 928, 93 L.Ed. 1089, 69 S.Ct. 653 (1949):

> So far as due process is concerned the only question is whether the tax in practical operation has relation to opportunities, benefits, or protection conferred or afforded by the taxing State.

The first prong of the Mobil test is clearly satisfied in this case. All that is necessary is that the business avail itself of the "substantial privilege of carrying on business within the State." Wisconsin v. J. C. Penney, supra. We do not understand CCA to question that nexus exists, which indeed it could not

contest in view of the fact that it has several manufacturing facilities located in California.

To succeed, CCA must show that the second prong of the test, the rational relationship test, is not met. It cannot succeed in this showing.

First, the fact that CCA conducts its operations in foreign countries through subsidiaries rather than as divisions provides no support for its argument. "The question is fundamentally one of whether a business should stand in a better position for purposes of determining income merely because it chooses to use a multiple corporation organizational scheme. We do not feel it should." Coca-Cola v. Department of Revenue (Oregon), 553 P.2d 778 (1975); Zale-Salem, Inc. v.

State Tax Commission (Oregon), 391 P.2d 601 (1964); Edison California Stores v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947). As this Court said in Mobil Oil, supra, at 440-41 and 523:

> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. General Motors Corp. v. Washington, 377 US 436, 441, 12 L Ed 2d 430, 84 S Ct 1564 (1964).

Second, the fact that foreign country operations are involved does not support CCA's due process

arguments in any manner. Bass, Ratcliff & Gretton Ltd. v. State Tax Commission, 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82 (1924); Mobil Oil Corp., supra.

CCA, to succeed, must answer a more basic question which has nothing to do with either the legal form chosen (subsidiary) or the nature of the forum (foreign) where its activities occur. CCA must show that the activities included in measuring the tax base before apportionment have no rational relationship to its activities in California.

It has long been established that:

> The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. (Wisconsin v. J.C.

> Penney, supra, at 445 and 271, and the cases cited therein.)

Furthermore, there is no requirement that a direct relationship be shown between the activity included in the tax base and the activity conducted within the state. "[T]he relevant constitutional test to establish the requisite nexus [is] . . . whether the facts demonstrate 'some definite link, some minimum connection . . .'" National Geographic Society v. California Board of Equalization, 430 U.S. 551, 51 L.Ed.2d 631, 97 S.Ct. 1386 (1977).

In establishing the rational relationship, the central concern of the inquiry should involve the activities within the state and how they relate to overall activities. As

pointed out by this Court in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 3 L.Ed.2d 421, 79 S.Ct. 357 (1959):

> The taxes imposed are levied only on that portion of the taxpayer's net income which arises from its activities within the taxing State. These activities form a sufficient "nexus between such a tax and transactions within a state for which the tax is an exaction."

The reason the test is concerned with the relationship between the in-state activities and the business as a whole is found in the measure of the tax.

> [I]n dealing with the rational relationship problem, we find the premise that a corporation in interstate/international business should pay a state for the governmental services and benefits provided by the state. (General Motors Corp. v. District of Columbia, 380

> U.S. 553, 14 L.Ed.2d 68, 85 S.Ct. 1156 (1965).)
>
> This notion is frequently expressed as requiring a relationship between the activities of the corporation and the net income attributed to the taxing state. However, the thrust of the notion has nothing to do with source of net income, if it is even possible to isolate net income. Its central concern is activity within the taxing state. (Richard G. Lathrop, "Due Process Consideration and the Apportionment of Dividend Income," Tax Notes, July 5, 1982.)

The test of due process has nothing to do with the source of income. Source determinations are inconsistent with the determination of net income. Net income is the result of determining gross income and subtracting from it deductions allowed by law. While in some instances it may be possible to isolate gross

income or receipts and assign them to a particular site, the same cannot be said for deductions such as interest and corporate overhead. These deductions are only assignable on a general basis and relate to the business operations as a whole. They eliminate any possibility of sourcing net income. They are the reason apportionment has become the rule. To attempt to argue that the source-of-income concept is meaningful to the rational-relationship concept "makes no economic sense and merely perpetuates separate accounting and specific allocation as alternatives to apportionment when in fact the gross income item involved has lost its gross income characteristic by the time it reaches the level of net

income to be apportioned among the taxing state." Ibid.

CCA may not successfully argue that the requirements of due process are violated because the activities of its subsidiaries in foreign countries are unrelated to its California activities. This argument has been advanced and rejected in a number of cases. Perhaps the best articulation for such rejection was provided by the Supreme Court of Maine in Albany International Corporation v. Halperin, 388 A.2d 902 (Maine, 1978), where it stated that to impart such a requirement that the tax was:

> . . . depend[ent] upon a showing of some connection between the local business and the production of particular income by one or more out-of-state elements of the business [would make the

> statute meaningless]. It could not have been the purpose of this legislation to create a system for rationalizing state income taxation of multistate or multinational business concerns, only to render it practically ineffective by requiring a showing that various items of out-of-state income, received in the regular course of business, were connected in some demonstrable way with activities of the taxpayer in Maine.

In a Florida case, Roger Dean Enterprises, Inc. v. State, 387 S.2d 358 at 362, the Court said:

> The taxpayer sub judice argues that to tax income from an out-of-state transaction by a foreign-chartered corporation amounts to a taking of its property without due process of law in violation of the Federal Constitution because there is no nexus between the transaction and the state of Florida. The requisite nexus is supplied when the corporation and some of its income producing activities are connected with the taxing

> jurisdiction. If this is the case, all of the corporation's income may be included in a fairly apportioned tax base for state income tax purposes. There is no requirement that each increment of income have a relationship to the taxing jurisdiction. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978); Northwestern States Portland Cement Co. v. State of Minnesota, 358 U.S. 450, 79 S.Ct. 357, 3 L.Ed.2d 421 (1959). [Emphasis added]

See also, Xerox v. Comptroller of Treasury (Maryland), 428 A.2d 1208 (1981); Gulf Oil Corp. v. Morrison, 120 Vt. 324, 141 A.2d 671 (1958); W.R. Grace & Co. v. Commissioner of Revenue (Massachusetts) 393 N.E.2d 330 (1979):

> Where there is apportionment by the standard three-factor formula, it is difficult to see how there [c]ould be any violation of due process because the formula itself normally will provide the rational relationship between the net income attributable

> to the state and the activities of the corporation in the taxing state. The rational relationship is not between the business activities of the corporation and specific items of gross income. If it were, we would be thrown back to the source syndrome and continue to chase our tails. (Lathrop, Tax Notes, supra)

The rational relationship is between the in-state and out-of-state activities, and the formula approach, by accounting for both, reflects this relationship.

As this Court stated in Mobil Oil Corp., supra, "the linchpin of apportionability in the field of state income taxation is the unitary business principle." Exxon Corp. v. Wisconsin, 447 U.S. 207, 65 L.Ed.2d 66, 100 S.Ct. 2109 (1980); F. W. Woolworth Co. v. Taxation and Revenue

Department, 50 Law Week 4957. As your Court quoted from the Idaho brief in ASARCO, Inc. v. Idaho State Tax Commission, 50 Law Week 4962:

> When income is earned from activities which are part of a unitary business conducted in several states, then the requirement that the income bear relation to the benefits and privileges conferred by the several states has been met.

Since the California courts have found that a unitary business exists, the requisite rational connection is shown. (It should be noted in passing that this is not the only way the connection can be shown. This language only indicates that once a unitary relationship is established the rational relationship is conclusively established.) As Justice Stevens pointed out in his dissent in

Mobil Corp., supra, at 462, the apportionable base and the formula must be considered together. It is the amount of the tax base apportioned to the state as compared to the activities in the state which is the critical test for due process consideration. As stated in Ott v. Mississippi Valley Barge Line Co., supra:

> Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the State.

CONCLUSION

The states' use of the unitary method satisfies the requirements of the due process clause. As this Court said in Wisconsin v. J. C. Penney, supra:

> A state is free to pursue its own fiscal policies, unembarrassed by the Constitution,

> if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.

California has clearly conferred substantial opportunities, protection and benefits on CCA and the tax should be sustained accordingly.

DATED: September 29, 1982.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

INTEREST OF *AMICUS CURIAE* 1

SUMMARY OF ARGUMENT 2

ARGUMENT:

I.

Whether A Unitary Business Exists Should Be Considered On A Case-By-Case Basis, And The Findings Of The Court Of Appeal Should Be Upheld 3

II.

Comparisons Of Wage Rates And Rates Of Profitability Cannot Be Used To Invalidate Combined Reporting As A Method Of Income Attribution 6

III.

Since Double Taxation Is A Corollary To Extra-territorial Taxation, Combined Reporting Does Not Cause Double Taxation For The Reasons Stated Above 10

IV.

Combined Reporting Does Not Prevent The United States From "Speaking With One Voice" 11

CONCLUSION 13

TABLE OF AUTHORITIES

Cases

ASARCO, Inc. v. Idaho State Tax Commission, 102 S.Ct. 3103 (1982) 3, 7
Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924) 9
Butler Bros. v. McColgan, 315 U.S. 501 (1942) 3, 9
Cal. Retail Liquor Dealers Ass'n. v. Midcal Alum., 445 U.S. 97 (1980) 5
Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinois Department of Revenue, et al., No. 81-349 ..... 1, 2, 8
Commission v. Culbertson, 337 U.S. 733 (1949) 4
Commission v. Duberstein, 363 U.S. 278 (1960) 4
Evco v. Jones, 409 U.S. 91 (1972) 5
Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980) 9
Fry Roofing Co. v. Wood, 344 U.S. 157 (1952) ... 5
Hans Rees' Sons v. North Carolina, 283 U.S. 123 (1931) 7
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 1, 11
John Deere Plow Co. of Moline v. Franchise Tax Board, 238 P.2d 569 (1951) Appeal dismissed 343 U.S. 939 (1952) 9
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) 7, 8, 9, 10, 11
Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) .. 7
F.W. Woolworth v. Taxation & Revenue Dept., 102 S.Ct. 3128 (1982) 5, 7

United States Constitution

Commerce Clause, Article 1, Section 8 ..... 1, 10
Fourteenth Amendment, Section 1 ..... 1, 6, 7, 10

Statutes

S. 655, 97th Cong. (proposed) 11
H.R. 1983, 97th Cong. (proposed) 11

Articles

Hellerstein and Hellerstein, *State and Local Taxation*, 539 (4th ed. 1978) 8

Keesling and Warren, *California's Uniform Division of Income For Tax Purposes Act*, pt. 1, 15 UCLA Law Review 156 (1967) 9, 10

Lathrop, *Due Process Considerations and the Apportionment of Dividend Income: A Dissent from the ASARCO and Woolworth Decisions*, Tax Notes, p. 3, July 5, 1982 7

Miscellaneous

124 Cong. Rec. 18402-18430, 18651-18670, and 19076-19078 (1978), U.S./U.K. Treaty (proposed) Article 9(4) 11

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CONTAINER CORPORATION OF AMERICA,

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Appellee.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

STATEMENT OF INTEREST

On April 19, 1982, oral argument was heard in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinois Department of Revenue*, et al., No. 81-349. On May 3, 1982, that case was restored for reargument, and probable jurisdiction was noted in the instant matter. In both of these cases a state has imposed a privilege or income tax measured by apportioning the combined incomes of domestic and foreign corporations. Since a decision in this case on either the unitary nature of Container's business, the due process argument regarding distortion of income, or the foreign commerce clause implications of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434

(1979), could have an impact on the ultimate decision in *Chicago Bridge & Iron* and, since this *amicus curiae* is a party in *Chicago Bridge & Iron*, it is submitted that this *amicus curiae* has a significant interest in the disposition of this case.

SUMMARY OF ARGUMENT

The threshold issue in this case is the last issue raised by Container. It is whether Container and its subsidiaries conducted a unitary business. If they did not, combined apportionment is not the appropriate method of state taxation, and this Court does not need to reach any constitutional issues. For the reasons stated by the lower court, Container and its subsidiaries did conduct a unitary business. The "substantial flow of goods" test suggested by Container should be rejected since it is an attempt to legislate in an area which should be considered on a case-by-case basis. Container has not shown that its California activities did not contribute to and depend on the flow of information, expertise and funds among the parent and its subsidiaries. Nor has Container shown that the income attributable to California is not rationally related to its intrastate values.

The distortion of income and double taxation arguments are premised on the validity of separate accounting. Consequently, they are not, in and of themselves, reasons for prohibiting the use of combined apportionment to attribute the income earned by a unitary business. If combined reporting does not cause extraterritorial taxation, then it cannot cause double taxation. Since combined reporting does not violate either a statute or a treaty of the United States, it does not prevent the United States from speaking with one voice.

ARGUMENT

I.

WHETHER A UNITARY BUSINESS EXISTS SHOULD BE CONSIDERED ON A CASE-BY-CASE BASIS, AND THE FINDINGS OF THE COURT OF APPEAL SHOULD BE UPHELD.

The unitary-business principle has been a familiar concept in tax cases for over 60 years. *ASARCO, Inc. v. Idaho State Tax Commission*,[1] 102 S.Ct. 3103, 3111 fn. 14. "[T]he application of the unitary-business principle requires in each case a careful examination . . . of the way in which the corporate enterprise is structured and operates. . . ." *Id.*, at 3115 fn. 22.

Container has asked this Court to abandon this case-by-case analysis and to adopt a "bright line" test whereby there must be a "substantial flow of goods" in order for a manufacturing or mercantile enterprise to be considered unitary. Appellant's Brief p. 47. This request should be rejected since it is an insufficient test and it is a call for judicial legislation.

One practical reason why the test is insufficient is that it would implicitly overrule *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). In that seminal case, centralized purchasing was found to result in more favorable prices than if the purchases were separately made by each branch store. "[T]he central buying division alone demonstrates that functionally the various branches are closely integrated." 315 U.S. at 508. The purchased goods were shipped directly from the various manufacturers, and there was no flow of goods between or among the central office and the outlying branch operations.

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[1] A Petition for Rehearing is pending.

Previous requests have been made for this Court to promulgate a "test," based on prior case law, in order to make it easier to determine when a partnership exists and when a transfer amounts to a "gift," *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Duberstein*, 363 U.S. 278 (1960). These requests were unequivocally rejected.[2] Just as all the relevant facts must be considered in order to determine whether a partnership exists or whether a gift has been made, a similar inquiry is necessary to determine the existence and contours of a unitary business. Thus, while a substantial flow of goods can be an important characteristic of a unitary business, it is not the *sine qua non* of combined apportionment.

The Court of Appeal reviewed the factual record and found that Container and its subsidiaries operated a unitary business. So long as there is a factual foundation in the record to support this finding and in the absence of "exceptional circumstances," the lower court's findings

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[2] In *Culbertson*, the Commissioner argued that the contribution of either "vital services" or "original capital" was essential to membership in a family partnership. The Court stated:

> Use of these "tests" of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, "whether the partnership is real within the meaning of the federal revenue laws" and makes decisive what we described as "circumstances [to be taken] into consideration" in making that determination. (footnote omitted). 337 U.S. at 741.

In *Duberstein*, the Commissioner asked the Court to promulgate a new "test"—namely, that gifts should be defined as transfers of property made for personal as distinguished from business reasons. The Court stated:

> We reject this invitation. We are of opinion that governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory frame-work, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. 363 U.S. at 284-85.

should not be reversed. *Evco v. Jones*, 409 U.S. 91, 95 (1972); *Cal. Retail Liquor Dealers Ass'n. v. Midcal Alum.*, 445 U.S. 97, 112-13 (1980); *Fry Roofing Co. v. Wood*, 344 U.S. 157, 160 (1952). The Court of Appeal found that there was a unity of ownership, use and operation between Container and its subsidiaries. J.S. at A-15. It further found that the business conducted within California was dependent upon or contributed to the operation of the business outside the state. J.S. at A-16. These conclusions were based on evidence that Container "assisted its subsidiaries in procuring paper, personnel and equipment" and that the "interchange between parent and subsidiaries in the areas of technical assistance, development and management policymaking is significant." J.S. at A-9 and A-16. The Court noted that Container constantly reviewed the financial reports of its subsidiaries; that it exerted control at the highest levels through its participation on the boards of directors of the subsidiaries and through the activities of the "foreign operations staff;" that the technical assistance was substantial; that the amounts of loans and guarantees were substantial; and that the annual reports showed that Container's self-image and the image it projected was that its worldwide activities constituted a single, unified business. J.S. at A-4, A-13 and A-15. All of this reflects a significant flow of information, expertise and funds between parent and subsidiary, and the application of this information, expertise and funds to the production of paperboard packaging contributes to the profitability of Container's operations in California.

Container compares its operations with those present in *F.W. Woolworth v. Taxation and Revenue Dept.*, 102 S.Ct. 3128 (1982), petition for rehearing pending, and draws the conclusion that it does not operate a unitary business with its foreign subsidiaries. The analogy is not sound. Woolworth conducted a retail merchandising business. Container engaged in the production and

distribution of paperboard packaging. A major difference between these two businesses is that the latter requires technological expertise at the production stage. This technological expertise was transmitted to Container's subsidiaries on a continuing basis through the technical service agreements, the sale and assistance in purchasing equipment, and the interchange of a small number of presumably well-chosen employees. J.A. 74-77; J.A. Exhibits 9-33. In addition, Container was significantly more active in the management of its subsidiaries than was Woolworth. This is evidenced by the larger foreign operations staff, the larger number of interlocking directors, the regular review of financial reports, and the substantial amount of loans or loan guarantees. J.A. 65-73. The foreign subsidiaries should not be considered discrete business enterprises in light of this continuous flow of technological expertise and management of activities.

II.

COMPARISONS OF WAGE RATES AND RATES OF PROFITABILITY CANNOT BE USED TO INVALIDATE COMBINED REPORTING AS A METHOD OF INCOME ATTRIBUTION.

Container's principal argument on the law is that combined apportionment violates the due process clause because the lower wage rates and allegedly greater profitability of foreign operations distort income attribution and produce extraterritorial taxation. Appellant's Br. pp. 11-26. This raises the question whether a difference in wage rates and rates of profitability constitute a proper basis for attack on the constitutional validity of combined apportionment. Combined apportionment is a method of income attribution which is used when two or more corporations conduct a unitary business. Therefore, the question may be stated more precisely as whether a difference in wage rates and rates of profitability in various geo-

graphic areas can be used to attack a method of attributing the income of a unitary business. For a simple reason, it cannot. Comparisons of wage rates and rates of profitability in different geographic areas are necessarily premised on notions of separate accounting. The unitary-business principle is a result of the inability to account separately for the income earned from interrelated business activity. Thus, it defies logic to oppose the unitary-business principle by recourse to the discredited separate accounting theory or any of its derivatives. At the most, separate accounting may be used to attack the reasonableness of an apportionment result in a particular case, but it cannot be used to invalidate apportionment as a method of taxation. See *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931).[3]

The initial premise in Container's argument is that "Combined apportionment under the unitary method assumes that a dollar of property, payroll and sales of the parent (Container) produces approximately the same

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[3] The Due Process Clause requires that the income attributed to the state be rationally related to the intrastate values. The unitary-business principle is one way to establish this relationship. *Mobil*, *supra*. Until *ASARCO*, *supra* and *Woolworth*, *supra*, another way was the "business income" test—namely, whether the intangible property producing the income was acquired and managed as an integral part of the business conducted, in part, in the taxing state. For another view, see Lathrop, *Due Process Considerations and the Apportionment of Dividend Income: A Dissent from the* ASARCO and WOOLWORTH *Decisions*, TAX NOTES, p. 3, July 5, 1982, wherein the author submits that the linchpin of apportionment is not the unitary-business principle; it is the reasonableness of the result. Under *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940), the linchpin is "whether the amount of net income attributed to the state has a rational relationship to the business activities carried on by the corporation in that state for which the state has given benefits and can ask compensation in return." *id.*, p. 20. Under this test, neither the unitary-business principle nor the "business income" test is necessary to determine a violation of due process.

amount of income as a dollar of property, payroll and sales of a subsidiary." Appellant's Br. p. 11. It then asserts that the wage rates and rates of profitability of its foreign subsidiaries, and of foreign subsidiaries in general, are significantly different from those of domestic corporations. Since these differences are not taken into account under combined reporting, it argues, the attribution of income is distorted, and this results in extraterritorial taxation and double taxation.

The error in Container's argument is that it ignores the unitary-business principle and it relies instead on factors which are totally irrelevant if a unitary business exists. In effect, the argument begs the question. Container's premise—that combined reporting assumes that a dollar of property, payroll and sales is equally profitable wherever situated—is a comment on how the method operates.[4] It is not relevant to the reason why the combined report is used. An attack on how an apportionment method operates is an attack on the application of the method. It is a request for relief. It is not an attack on the facial validity of the method. It does not undercut the appropriateness of apportioning the income of a unitary business. Even Hellerstein and Hellerstein, *State and Local Taxation*, 539 (4th ed. 1978), admit that this argument relates only to the issue of relief from formulating apportionment.

The reason why the combined report is used is that, if a unitary business exists, it is misleading to characterize the income earned by that business as having a single, identifiable "source." See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 and 440-41.

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[4] Chicago Bridge & Iron and the Solicitor General each rely on this same assumption about combined reporting. Brief of Appellant at 11, 36 and 41, and Memorandum For The United States As Amicus Curiae at 13, *Chicago Bridge & Iron, supra*.

Consequently, the appropriateness of the combined report depends on whether a unitary business exists or whether several discrete business enterprises exist. None of the relevant cases indicate that a difference in wage scales has any bearing on whether one corporation is "separate and distinct" from another corporation or whether the two are "related." See *Mobil, supra*; *John Deere Plow Co. of Moline v. Franchise Tax Board*, 238 P. 2d 569 (1951), appeal dismissed 343 U.S. 939 (1952); Brief for Appellant at 33, *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924). Nor does a difference in the rate of profitability have any bearing on this issue. See *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980); *Butler Brothers v. McColgan*, 315 U.S. 501 (1942).

The fact that Container has presented nothing more than a separate accounting analysis is evidenced by the numerous references to separate accounting as its standard of comparison. Appellant's Br. pp. 13-18, 21-22.

Container illustrates its argument by posing an example of one company located in Columbia which operates at a profit and a second company located in California which operates at a loss. Appellant's Br. p. 15, note 4. It contends it is unfair to use a combined report in this situation because one half of the income earned in Columbia would be attributed to California. Leading commentators have already answered this hypothetical:

> The idea that a company might sustain losses from business transactions in certain areas and realize profits from other business transactions in other areas is commonly held and is fully in accord with what may be referred to as conventional conceptions of source of income. But such conventional conceptions are both archaic and myopic. A broader conception of unity is needed to keep pace with the increasingly complex commercial, industrial and financial world. (footnote omitted.) Keesling and

Warren, *California's Uniform Division of Income for Tax Purposes Act*, pt. 1, 15 UCLA Law Review 156, 172 (1967).

Among other things, Keesling and Warren suggest that the ownership of numerous operations, some of which will operate at a loss at any given time, is necessary in order to protect against the effects of market uncertainty. *id.*

The question posed by appellant is whether worldwide combined reporting is repugnant to the Due Process and Foreign Commerce Clauses. The litigation strategy has been similar to that employed in *Mobil*, 445 U.S. at 434, wherein Mobil challenged the tax base rather than the fairness of the formula. Appellant does not seriously argue that it is entitled to relief from an otherwise valid method of formulary apportionment. Yet the reasons relied on by appellant, differences in wage rates and rates of profitability, at most relate to the fairness of the apportionment formula rather than the constitutional validity of combined reporting. These reasons relate to the application of combined reporting rather than the reasons for its use. Thus, appellant has not shown that the use of a combined report to apportion the income of a unitary business is invalid as a constitutional matter.

III.

SINCE DOUBLE TAXATION IS A COROLLARY TO EXTRATERRITORIAL TAXATION, COMBINED REPORTING DOES NOT CAUSE DOUBLE TAXATION FOR THE REASONS STATED ABOVE.

In its argument with respect to the Due Process Clause, Container asserted that the combined reporting method attributed almost $4 million more per year to the United States than the arms-length method did. Appellant's Brief p. 17. It claimed that if California taxed any part of

this $4 million, that would be extra-territorial taxation. Appellant's corollary to this point is that foreign countries can and do tax this same income, and this results in double taxation in violation of one of the two precepts enunciated in *Japan Line, supra.*

For the reasons stated above, appellant has not shown that combined reporting attributes to California any more income than is earned there. Since Container operates a unitary business, it is a mistake to rely on separate accounting and to characterize certain income of the business as having a single identifiable source in a foreign country. Just as combined reporting does not automatically cause extraterritorial taxation, even when it includes corporations which operate in foreign countries, it does not automatically cause double taxation.

IV.

COMBINED REPORTING DOES NOT PREVENT THE UNITED STATES FROM 'SPEAKING WITH ONE VOICE'.

Combined reporting does not violate either a statute or a treaty of the United States. For almost 20 years Congress has considered legislation which would regulate state taxation of income. *Mobil*, 445 U.S. at 448. Current proposals would prohibit the States from using worldwide combined reporting. S.655, 97th Cong.; H.R. 1983, 97th Cong. Congress has not passed this legislation. Article 9(4) of the U.S./U.K. Treaty would also have prohibited the use of combined reporting insofar as those signatories were concerned. However, the U.S. Senate ratified the treaty only after that prohibition was excluded. This would have been a useless act if current treaties implicitly contained that prohibition.

The fact that an international standard of taxation does not exist is further evidenced by the lack of an

international administration to enforce this standard. When a corporation sells a product or sells a service, or loans money to an affiliated corporation, a determination must be made as to the "arms-length" character of the transaction. In the course of a year, millions, if not billions, of these transactions are made at different levels within the corporations and at different geographical locations. A state auditor may disagree with the estimate of the taxpayer on many of these transactions. A federal auditor may disagree with both the taxpayer and the state auditor. Auditors from foreign countries may disagree with each other as well as with the taxpayer, the state auditor and the federal auditor. Thus, instead of speaking with one voice, these transactions bring forth a babble of voices. Simply put, there is no international standard of taxation, and neither California nor any of the other states have prevented the United States from speaking with one voice on this matter.

CONCLUSION

For the foregoing reasons, *Amicus Curiae* State of Illinois respectfully requests this Court to affirm the decision of the Court below.

Respectfully submitted,

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JUL 30 1982

81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

MOTION FOR LEAVE TO FILE

BRIEF AS AMICI CURIAE

The International Bankers Association in California and Akai Electric Co., Ltd. hereby respectfully move for leave to file their brief as amici curiae in the case, No. 81-523, which was previously filed in Chicago Bridge & Iron Company v. Caterpillar Tractor

No. 81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Supreme
Court of the State of California

MOTION OF

The International Bankers Association
in California
Akai Electric Co., Ltd.
an Amici Curiae
in Support of Appellant

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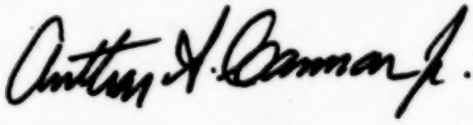
Co., Illinois Department of Revenue, et al., No. 81-349. The brief was filed in this latter case pursuant to consent of the parties and we request leave of the Court to consider this brief in the Court's review of the Container case.

Respectfully submitted,



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The International Bankers Association In California

Akai Electric Co., Ltd.

July 30, 1982.

No. 81-349

IN THE

Supreme Court of the United States

October Term, 1981

CHICAGO BRIDGE & IRON COMPANY,

Appellant,

vs.

CATERPILLAR TRACTOR CO., ILLINOIS DEPARTMENT OF REVENUE, *et al.*,

Appellees.

On Appeal from the Supreme Court of Illinois.

Brief for The International Bankers Association In California, Akai Electric Co., Ltd., as Amici Curiae in Support of Appellant.

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TABLE OF CONTENTS

Page

Statement of Interest 1

Summary of Argument 3

Argument 5

I.

The Principles Established in Japan Line Concerning the Requirements of the Foreign Commerce Clause Are Fully Applicable to a Case Involving a Franchise or Corporate Income Tax Imposed by a State Utilizing Worldwide Apportionment 5

II.

Foreign Countries With Whom We Trade Object to World-Wide Apportionment Because It Creates Unreasonable Burdens of Compliance, Is Distortive in the Context of International Tax Relations, and May Result in Retaliation Against the United States 9

1. Separate Accounting Is Used by All Countries to Tax Foreign Business Activities 13
2. The Burden of Compliance With World-Wide Apportionment Is Unreasonable 15
3. World-Wide Apportionment Discriminates Against Foreign Companies Attempting to Establish Business Activities in the United States 17
4. Economic Factors Are Not Substantially Equal Among the Nations, a Circumstance Which Results in Unreasonable Distortion in World-Wide Apportionment 19

Page

5. Changes in Currrency Conversion Rates Artificially and Unreasonably Affect the Amount of Tax Liabilities Determined Pursuant to World-Wide Apportionment 21

6. Conclusion 22

Appendix. International Protests To the Department of State, Washington, D.C., Dated March 19, 1980 ..... App. p. 1

Copyright (C) 1981 The Nihon Keizai Shimbun (Japan Economic Journal) 4

Resolution for Urging an Abolition of the Unitary Tax Formula Based on World Wide Income 6

Resolution of the Council on Unitary Taxation 9

Note from United Kingdom (March 25, 1980) 13

Letter from Secretary Blumenthal to Martin Huff, California Franchise Tax Board (Feb. 15, 1977) . 17

TABLE OF AUTHORITIES CITED

Cases

Page

Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924) 6

Brown v. Maryland, 25 U.S. (12 Wheat.) 419 (1827) 7

Caterpillar Tractor Co. v. Daniel J. Lenckos, 84 Ill.2d 102, 417 N.E.2d 1343 (May 1980) 5

EVCO v. Jones, 409 U.S. 91 (1972) 9

Fargo v. Hart, 193 U.S. 490 (1904) 19

Inman Steamship Co. v. Tinker, 94 U.S. 238 (1877) . 7

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 3, 5, 6, 7, 8, 9, 11, 12, 22

J. D. Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938) 9

Missouri v. Holland, 252 U.S. 416 (1920) 7

Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980) 5, 6, 18, 19

Mobile County v. Kimball, 102 U.S. 691 (1881) 7

Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) 7

United States v. Belmont, 301 U.S. 324 (1937) 8

United States v. Pink, 315 U.S. 203 (1942) 8

Zschernig v. Miller, 389 U.S. 429 (1968) 8

Constitution

United States Constitution, Art. I, Sec. 8, Clause 3 ..... 3, 7

Miscellaneous — Page

House Report 5205 12

Hearings on State Taxation of Interstate Commerce and World-Wide Corporate Income: Hearings on S. 983 and S. 1688 Before the Senate Subcomm. on Taxation and Debt Management Generally, Senate Finance Comm., 96th Cong., 2d Sess., 40, 44 (1980) .. 10, 20

Hearings on the Tax Convention With the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess., 196-97 (1977) 12, 14

Switzerland's Federal Law Relating to Banks and Savings Banks, Sec. 14, Arts. 41, 47 15

United States Treasury Department's Model Income Tax Treaty of May 17, 1977, 1 CCH Tax Treaties, par. 153, at 223 13

Statutes

California Administrative Code, Title 18, Reg. 25130(a) (May 29, 1971) 21

California Revenue and Taxation Code, Sec. 26422 (West 1979) 21

Internal Revenue Code of 1954, Sec. 891 12

Textbooks

P. Hartman, Federal Limitations on State and Local Taxation 560 (1981) 23

Rudolph, State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups, 25 Tax L. Rev., 171, 181 (1970) 19

The Federalist No. 22 (A. Hamilton) 7

The Federalist No. 42 (J. Madison) 7

No. 81-349

IN THE

Supreme Court of the United States

October Term, 1981

CHICAGO BRIDGE & IRON COMPANY,

Appellant,

vs.

CATERPILLAR TRACTOR CO., ILLINOIS DEPARTMENT OF REVENUE, *et al.*,

Appellees.

Brief for The International Bankers Association in California, Akai Electric Co., Ltd., as Amici Curiae in Support of Appellant.

Statement of Interest.

This Brief is submitted with the written consent of all parties on file with the Clerk of this Court. The Amici fully support the position of Appellants in this case.

The Amici include a trade association of approximately 100 foreign banking institutions doing business in California and other States,[1] and a Japanese parent corporation having

[1]The International Bankers Association In California is a private, non-profit organization the members of which have their principal offices in more than twenty-four foreign countries and maintain California agencies or branches, and/or have wholly or partially owned domestic banks operating in California. The purpose of the Association is to further the development of the United States and California business economy and climate through considcration of issues affecting the banking community and reporting of the members' views to appropriate authorities.

United States subsidiaries operating in California and other States.

Particular members of the trade association may enjoy an advantage in California under the combined return-unitary business formula using world-wide calculations (hereinafter referred to as "world-wide apportionment") compared with a tax system based on separate accounting for income earned from arm's-length transactions in the jurisdiction (hereinafter referred to as "separate accounting"). Notwithstanding such advantage to certain members, the trade association and its members are concerned over the problems to foreign commerce presented by world-wide apportionment if used by some or all of the States. Their interest therefore, is not to support one system of taxation because of a perceived financial advantage. As a result of the foreign banking community's unique vantage point and perspective, the members and the association urgently wish to express their concern over the significantly adverse effect of world-wide apportionment upon the foreign relations of the United States and upon foreign commerce generaliy.

The Amici corporation is a foreign parent company whose California subsidiary is challenging the use of world-wide apportionment by the State of California. The Amici corporation has a different perspective than the Appellants with respect to the questions before this Court because it is a foreign-based multinational corporation.

Any decision of the Court in this case will affect foreign-based business entities having contact with the United States either directly or through an affiliated entity (such foreign-based business entities are hereinafter sometimes referred to as foreign multinational corporations, foreign companies or by other similar terms). The problems which foreign companies have experienced with world-wide apportionment are not presented by the facts of this case as vividly as if a foreign company were involved. The special concerns of the Foreign Commerce Clause cannot be understood as

fully as it should be from the vantage point of a domestic parent company. Finally, most treaties reserve to the contracting nation the sovereign right to tax their domestic entities as they shall determine. Taxing foreign companies, however, is a matter having significantly different dimensions.

Summary of Argument.

This case presents for decision the threshhold question whether the rationale of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), extends to corporate income tax cases. Considerations of the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3), strongly support testing States' powers to impose income taxes on foreign source income of domestic or foreign taxpayers against the standards set forth in *Japan Line*.

If *Japan Line* applies, the question for decision is *whether* world-wide apportionment infringes upon the interest protected by the Foreign Commerce Clause. The two standards peculiar to foreign commerce which were adopted by *Japan Line*, and which are in addition to standards applicable to interstate commerce generally, are whether the state tax (1) impairs the power of the Federal government to regulate commerical relations with foreign countries thereby frustrating its ability to speak with one voice in such affairs, or (2) creates an unreasonable risk of duplicative taxation. World-wide apportionment as used by Illinois, California and a few other states apportions to the state taxing jurisdiction an amount of income subject to tax which bears no relation to the actual amount of net income earned within the jurisdiction based on separate accounting methods. Duplicative taxation occurs with respect to foreign source income to the extent to which the amount of apportioned income exceeds actual income determined under separate accounting methods. The reason is that income earned outside the United States by the unitary group of corporations has already been taxed fully, without apportionment, by the

country or countries in which earned through tax systems based on separate accounting methods. There is no way to avoid the risk of duplicative taxation under these circumstances, that is unless the taxing authorities of the states convince most foreign governments to change from the universally followed separate accounting approach to some type of world-wide apportionment formula.

The problems of duplicative taxation, distortion and inconsistencies resulting from imposition of world-wide apportionment by States, which might otherwise be tolerated under the Commerce Clause in the case of interstate commerce, become magnified to the extreme in the context of foreign commerce. Our trading partners have actually issued warnings to us that they are concerned about discrimination against foreign companies which is inherent in world-wide apportionment. The risk of retaliatory action cannot be controlled or resolved by the United States Congress or through our judicial system. The decision to retaliate rests with the foreign country. International disputes can only be resolved by the Federal government pursuing the goals of tax harmony, tax simplification and avoidance of duplicative taxation through networks of treaties and bilateral and multilateral trade agreements and negotiations, matters which are exclusively within the Federal government's responsibility and concern.

The States should not be limited in the exercise of their Constitutional rights to tax at their discretion income from business activity of foreign and domestic corporations earned within the United States, whether by separate accounting or by some type of unitary business method of apportionment consistent with the requirement of the Interstate Commerce Clause. Income earned outside the United States, however, should not be subjected to world-wide methods of apportionment but rather should be taxed by systems which do not create risks of duplicative taxation.

ARGUMENT.

I.

THE PRINCIPLES ESTABLISHED IN *JAPAN LINE* CONCERNING THE REQUIREMENTS OF THE FOREIGN COMMERCE CLAUSE ARE FULLY APPLICABLE TO A CASE INVOLVING A FRANCHISE OR CORPORATE INCOME TAX IMPOSED BY A STATE UTILIZING WORLD-WIDE APPORTIONMENT.

The Court below concluded that this Court's decision in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) was "obviously distinguishable" from the present case since no instrumentality or item of foreign commerce was involved and world-wide apportionment does not "affect Federal authority in governing foreign commerce".[2]

In *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), this Court distinguished *Japan Line* on the four following grounds:[3] (a) *Japan Line* involved an ad valorem property tax assessed directly upon instrumentalities of foreign commerce; (b) the policies favoring allocation of property to a specific situs in property tax cases do not have applicability to income tax cases; (c) *Japan Line* was concerned with duplicative taxation at the international level whereas *Mobil Oil* presented questions of multiple taxation among the States; and (d) *Japan Line* presented actual duplicative taxation which was capable of remedy only by the Court's decision whereas the record in *Mobil Oil* set forth only a risk of such taxation.

Of the four grounds of distinction, only one appears relevant to cases involving world-wide apportionment, *i.e.*, that *Japan Line* was a property tax case involving an instrumentality of foreign commerce. As demonstrated in sub-

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[2]*Caterpillar Tractor Co. v. Daniel J. Lenckos*, 84 Ill.2d 102, 119, 417 N.E.2d 1343 (May 1980), which appears in Appendix C to Appellant's Jurisdictional Statement in its Appeal to this Court. *See also Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[3]445 U.S. at 448.

sequent paragraphs, most cases involving world-wide apportionment present a record of actual duplicative taxation at the international level. Further, the specific allocation rules unique to property tax cases will not be relied upon by foreign multinationals in any challenge to world-wide apportionment.

The decision in *Mobil Oil* was narrowed solely to questions of multistate taxation and the issue of the States' power to tax previously taxed foreign source income was avoided.[4] This Court must now decide whether the principles enunciated in *Japan Line* concerning the special concerns of foreign commerce should be applied to duplicative taxation and other burdens for purposes of state corporate income taxes. The Amici strongly believe that the underpinnings of the Foreign Commerce Clause compel the principles enunciated in *Japan Line* to be so applied and that the *Japan Line* opinion should not be narrowed to be relevant only to cases involving instrumentalities of foreign commerce.

The Federal government was brought into being to assure the national and not parochial conduct of foreign affairs and uniform regulation of foreign commerce, matters of preeminent national concern. The States have no role in this area.

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[4] *Id.* at 447. The Court said:

> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. Thus, the only inquiry of constitutional dimension is the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation. Once appellant's argument is placed in this perspective, the presence or absence of taxation abroad diminishes in importance.

The Court in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), upheld the imposition in 1918 of a New York privilege tax on a British ale manufacturer which sold its product in New York. The case is clearly distinguishable from the present case because plaintiff failed to demonstrate that the New York method of apportionment had produced an unreasonable result through duplicative taxation or otherwise for purposes of the Due Process and Commerce Clauses

Article I, §8, clause 3 and the Supremacy Clause of the Constitution require the States to subordinate their laws, judicial decisions, and actions to the requirements of Federal uniformity in areas where such is essential. This Court has often stated that the United States must speak with one voice in matters of foreign affairs or commerce or it cannot credibly speak at all.[5] In distinguishing interstate commerce's tolerance for some duplicative taxation (citing *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978)), this Court underscored the special sensitivity of foreign commerce to the risk of duplicative taxation:[6]

> This case, by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist and cannot be policed by this Court at all. Moorman, finally, concerned interstate commerce. This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned. (footnote omitted)

The vesting of such power in the national government not only forecloses a state from conducting its own foreign affairs but also requires a state to subordinate to the national interest its policies in areas where the local interests are usually primary. Thus, where a national interest approaches "the first magnitude," the President with the consent of the Senate may by treaty set aside local laws regulating game birds.[7] By the less formal means of "a protocol, a modus

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[5]*Japan Line, supra* note 2, at 449. *See Mobile County v. Kimball*, 102 U.S. 691, 697-98 (1881); *Inman Steamship Co. v. Tinker*, 94 U.S. 238, 245 (1877); *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 445-46 (1827); *The Federalist No. 22* (A. Hamilton); *The Federalist No. 42* (J. Madison).

[6]*Japan Line, supra* note 2, at 455-56.

[7]*Missouri v. Holland*, 252 U.S. 416, 435 (1920).

vivendi, a postal convention" or an exchange of correspondence with another nation, a state may be compelled to defer to international policy in a peculiarly local area such as that of property ownership or insurance regulation.[8] Even without the necessity of prior action by the national government, a state probate law becomes unenforceable when something more than an "indirect" or "incidental" effect on foreign relations is threatened, since in such a case "international controversies of the gravest moment could result" even though a wrong is "imagined" and not "real".[9] In *Zschernig v. Miller*, 389 U.S. 429 (1968), the Court said:[10]

> It seems inescapable that the type of probate law that Oregon enforces affects international relations in a persistent and subtle way. * * * The present Oregon law is not as gross an intrusion in the federal domain as those others might be. Yet, as we have said, it has a direct impact upon foreign relations and may well adversely affect the power of the central government to deal with those problems.

This court concluded in *Japan Line* that a state property tax on instrumentalities of foreign commerce must be voided if it either impairs the power of the Federal government to regulate commercial relations with foreign governments, *i.e.*, to speak with one voice in such matters, or creates a substantial risk of duplicative taxation.[11]

In matters of foreign commerce, an inquiry must be made whether disruptions or difficulties in relations with foreign countries or in trade will likely occur if a state tax is permitted to be imposed. It should make no difference whether it is a property, gross receipts, sales, franchise or corporate

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[8]*United States v. Belmont*, 301 U.S. 324, 330 (1937). *See also United States v. Pink*, 315 U.S. 203, 233-34 (1942).

[9]*Zschernig v. Miller*, 389 U.S. 429, 440 (1968).

[10]*Id.* at 440-41.

[11]*Japan Line*, *supra* note 2, at 451.

income tax.[12] The effect may be perceived more vividly in the case of instrumentalities of interstate commerce as in *Japan Line*. However, any disruption to foreign commerce or foreign relations, from whatever source or type of state action, requires the special sensitivity to the interests of the Foreign Commerce and Supremacy Clauses. There is no reason to presume that the need for national uniformity under the Foreign Commerce Clause would exist in the case of property taxes and not with respect to corporate income taxes. The potential for retaliation may, in fact, be greater in the case of corporate income taxes than with respect to property taxes due to the more significant amounts involved.

II.

FOREIGN COUNTRIES WITH WHOM WE TRADE OBJECT TO WORLD-WIDE APPORTIONMENT BECAUSE IT CREATES UNREASONABLE BURDENS OF COMPLIANCE, IS DISTORTIVE IN THE CONTEXT OF INTERNATIONAL TAX RELATIONS, AND MAY RESULT IN RETALIATION AGAINST THE UNITED STATES.

World-wide apportionment is perceived by the major foreign countries with whom we trade as unfair and discriminatory[13] to foreign trade and any investment which foreign companies may make in this country. Their outrage is directed to the principle of world-wide apportionment. The heart of the discrimination perceived by our trading partners is the difference in the methods used by foreign countries in taxing U.S. companies in foreign countries (*i.e.*, separate accounting) compared with the imposition of world-wide apportionment upon foreign citizens and domiciliary com-

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[12]*See, e.g., EVCO v. Jones*, 409 U.S. 91 (1972) (sales tax issue); *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938) (gross income tax).

[13]In the context of any given set of facts such discrimination may violate the Due Process Clause. Whenever the word "discrimination" is used herein, however, the context is the reaction of our foreign trading partners to what they perceive as discrimination and the effect this reaction has upon foreign commerce.

panies by the States, a difference which results in duplicative taxation.

In a prepared statement submitted to a Senate Finance Subcommittee in June, 1980, the Assistant Secretary of the Treasury for Tax Policy, Donald C. Lubick, stated that world-wide apportionment[14]

> has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary systems differ from the arm's-length method which is used by the Federal Government and is generally accepted in international practice.

International protests were submitted in March, 1980 to the State Department by the nine countries comprising the European Economic Community.[15] Japan formally objected to world-wide apportionment in November, 1981, by including it as one of the most important of the fourteen points of trade dispute which Japan has with the United States.[16] In November and December of 1981, Japanese trade associations representing virtually every major business entity in Japan formally adopted resolutions of protest against world-wide apportionment used by the States.[17] In 1980,

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[14]*State Taxation of Interstate Commerce and World-wide Corporate Income: Hearings on S. 983 and S. 1688 Before the Senate Subcomm. on Taxation and Debt Management Generally, Senate Finance Comm.*, 96th Cong., 2d Sess. 44 (1980).

[15]The note is dated March 19, 1980, a copy of which is included in the Appendix hereto, at App. 1-3.

[16]*U.S. Will be Asked to End Non-Tariff Barriers*, JAPAN ECON. J., (Nov. 10, 1981) For the convenience of this Court, the entire article is included in the Appendix hereto, at App. 4-5.

[17]Copies of the resolutions are included in the Appendix hereto, at App. 6-12. The resolutions were adopted by the Keidanren (Federation of Economic Organizations, Japan), representing 916 corporations, associations and business organizations in Japan, and a committee of Japanese Corporations formed in the Kansai province of Japan, composed of 49 companies having U.S. interests. The action of the two groups indicates the breadth and depth of the Japanese sensitivity and opposition to the States' use of world-wide apportionment.

the United Kingdom, France and Canada submitted formal letters of protest to the State Department concerning the use of world-wide apportionment.[18]

We have been warned by our major foreign trading partners of their objections to the principles of world-wide apportionment, especially the unfairness of its use by a state when all countries use the separate accounting system in taxing U.S. companies. Their concern is with respect to the principles of the tax. As is the case with many members of the Amici trade association, world-wide apportionment sometimes produces less state income tax to a company than would otherwise be paid under the separate accounting method utilized in the arm's-length approach. It is not surprising that Caterpillar Company benefited by world-wide apportionment and that many U.S. companies do, including the Amici supporting Caterpillar before the Illinois Supreme Court. However, foreign companies generally find world-wide apportionment objectionable even if they benefit from it. To the best of our knowledge, no foreign company or country is filing an amicus brief before this Court in support of that tax system.

This Court recognized in *Japan Line* the adverse consequences which the entire nation might suffer if countries began to retaliate against the United States over the tax policies of one or more states.[19]

> If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American

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[18]A copy of the United Kingdom note is included in the Appendix hereto, at App. 13-16. The French note may be found at 1 CCH Tax Treaties, ¶ 2836A, at 2819-7D. The Canadian note may be found at 1 CCH Tax Treaties, ¶ 1317P, at 1249-31 to 1249-32.

[19]*Japan Line*, *supra* note 2, at 450-51.

> transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this nation from "speaking with one voice" in regulating foreign commerce. [footnote omitted]

The United States retaliated against France in the 1930's when it imposed a tax on dividends paid by U.S. parent corporations having French subsidiaries, which was apportioned on the basis of a U.S. company's French assets to its total world-wide assets.[20] Congress enacted a law following repeated warnings to France (which were not heeded as quickly as Congress wished) allowing the President of the United States to double the U.S. tax rate against citizens or corporations of a foreign country which imposed what would be viewed by the President as a discriminatory or extraterritorial tax on U.S. citizens or corporations.[21] The Government of France thereafter resolved the problem by ratifying a treaty with the United States to avoid such tax.[22]

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[20]*Hearings on the Tax Convention with the United Kingdom, the Republic of Korea, and the Republic of the Philippines. Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 196-97 (1977) (Statement of John S. Nolan).

[21]Section 891, Internal Revenue Code of 1954, as amended, is the successor statute.

[22]A current example of pending retaliatory legislation by the United States against a foreign country is H.R. 5205 introduced in the House of Representatives in December, 1981. This bill is intended as the United States' response to a Canadian law which prohibits a Canadian business from deducting the cost of advertisements placed on United States border television or radio stations. H.R. 5205 provides that a United States business cannot deduct the cost of its advertisement on Canadian border television or radio stations. The proposed legislation is an example of retaliatory action using our tax laws to protest a foreign law which adversely affects United States interests. Foreign countries may use similar retaliatory legislation to object to world-wide apportionment.

It takes time before matters concerning a city, province, state or district tax are raised to the level of discourse, treaty negotiation or protest between countries. Discourse, treaty negotiations and formal protests have now occurred between the United States and foreign governments with respect to world-world apportionment. No state should upset international expectations by exercising its taxing authority in a manner which is clearly asymmetrical and distortive to a system of taxation which has been nurtured through decades of negotiations and is currently being followed by all countries in taxing foreign citizens and foreign domiciliary corporations.

1. Separate Accounting Is Used by All Countries to Tax Foreign Business Activities.

The context in which such objections are raised is that, in practice, all countries utilize separate accounting principles to tax business activities of citizens and corporations of foreign countries.[23] This system has been developed over the years through the negotiation of major disputes between and among nations, and in the development of the vast and complex system of treaties among nations. The practicalities

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[23]Attached in the Appendix hereto, at App. 17-19, is a copy of a letter from W. Michael Blumenthal, Secretary of the Treasury, to the California Franchise Tax Board, dated February 15, 1977, which states in part as follows:

> Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The separate accounting approach is the basis for the negotiation of our tax treaties with foreign countries. See the United States Treasury Department's Model Income Tax Treaty of May 17, 1977, 1 CCH Tax Treaties, ¶153, at 223.

of international trade and commerce require that the work toward tax harmony in this area be respected.

The protests raised by our trading partners about duplicative taxation and compliance burdens, therefore, constitute clear and unequivocal warning signals to the United States that the principle of world-wide apportionment is objectionable and will cause mischief in international affairs. The efforts of the Federal government to negotiate treaties restricting the right of states to impose world-wide apportionment indicates the Executive Branch's concern over its adverse impact upon our foreign commerce.[24]

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[24]Although the 1978 Senate vote in favor of ratifying the U.S./U.K. Tax Treaty was 49 yeas and 32 nays, the Treaty was not ratified with the restriction against a state's use of world-wide apportionment because the necessary two-thirds vote was not achieved. Opposition to the Treaty was led by Senator Church. The following statement was made by Senator Church during the course of the hearings on the Treaty and aptly summarizes the attitude of those Senators who voted in opposition to ratification.

> I think what the States are saying is that they ought to be allowed to make the decision of what system of taxation they should apply, and that if they are not allowed to make the decision, then that ought to be a judgment reached by the Congress as a whole, based upon national tax policy, and it ought not to be approached by the treaty route by singling out a certain country and starting there. The only handle the Congress has upon that is the ratification of the treaty by the Senate. The House of Representatives has traditionally had the prerogative under the Constitution of considering revenue measures first and determining tax policy initially, before it comes to the Senate.
>
> So, here we have a method that circumvents the traditional and constitutional arrangement, or the normal arrangement, for determining our tax policy. Whether the unitary system or the arm's length system is the best, I would not know. But, the fact that the States think they ought to have the right to decide which kind of tax to impose is the issue here.

Hearings on the Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, supra note 20, at 21. The same concern over protection of state's rights is prevalent today in consideration of various bills which would prohibit the use of world-wide apportionment. As a practical and political matter, therefore, neither the Executive nor Legislative Branches of government are likely to assess and balance the needs of the States to exercise their Constitutional powers to tax against the Constitutional interests of Federal uniformity in substantive matters of foreign commerce.

2. The Burden of Compliance With World-Wide Apportionment Is Unreasonable.

Our major trading partners view world-wide apportionment as unfair and discriminatory to foreign commerce for many reasons. The problem of compliance with a State's concept of world-wide apportionment is significantly greater to a foreign company than to a U.S. multinational company. World-wide records and financial information of foreign-based companies are not maintained in accordance with the standards required by a State's taxing system. U.S. multinational companies, on the other hand, routinely maintain books, records and financial information pursuant to accounting systems which are compatible with a state's regulations in most respects.

This Court should not permit a state's taxing power to be used in a manner which would coerce foreign multinational companies to maintain their books and records and those of their world-wide affiliate entities in substantial conformity with the accounting requirements of one or more of our States.

Foreign secrecy, national security and general non-disclosure laws can create an impossible dilemma for foreign multinational companies in disclosing world-wide financial information for state tax and other purposes. These laws sometimes provide that secret or confidential financial information of the business cannot be disclosed. If disclosed to any person (including a foreign government entity), serious civil and/or criminal penalties result.[25] However, the

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[25] *See, e.g.*, Switzerland's *Federal Law Relating to Banks and Savings Banks*, Section 14: *Responsibility and Penal Provisions, which provides in part:*

> *Article 41*. Persons entrusted with the management, superintendence, supervision and the control of the bank are liable to the bank as well as to each associate, shareholder or creditor for the damage caused by intentional or negligent violation of their duties.
>
> *Article 47*. 1. Whoever divulges a secret entrusted to him in his capacity as officer, employee, mandatory, liquidator or commissioner of a bank, as a representative of the Banking Commission, officer or employee of a recognized auditing company, or who has become aware of such a secret in this capacity, and whoever tries to induce others to violate professional secrecy, shall be punished by a prison term not to exceed six months or by a fine

failure to disclose this information in the United States may result in the officers being held in contempt of court. This dilemma is particularly acute in the international banking area where bank secrecy laws may be restrictive and may vary considerably from country to country.

Foreign companies engaged in national security or defense related activities may be prohibited by the laws of foreign countries from disclosing financial information regarding their business activities, including their property, payroll or sales. Disclosures by these companies, necessary for the computation of apportionable income, may therefore be prohibited by foreign law.

The practical consequences of applying world-wide apportionment is clearly evident in connection with the preparation of a combined return. To ensure the integrity of the figures upon which the return is made, offices of state governments may have to be established in foreign countries in order to review the books and records of multinational companies which have affiliated entities doing business in the United States. This is merely a logical extension of the fact today that offices of state taxing authorities are commonly maintained in cities of other States for such purposes.

At present there is no system whereby state authorities can verify the accuracy of world-wide net income, property values, payroll or sales of foreign multinational companies. In the absence of such a system, state taxing authorities commonly rely upon financial information contained in the annual reports of such foreign multinational companies which were prepared for purposes having nothing to do with tax reporting purposes. Taxation on this basis would be tantamount to the approval by this Court of taxing some U.S. companies based solely upon information carried in their published annual reports without adjustment for items of income, deduction and credits otherwise permitted under the taxing system.

World-wide apportionment may result in attempts by the various States imposing such a formula to verify the information submitted to it. It is submitted that the practical difficulties presented by such circumstances raise serious questions concerning the ability of the United States to carry out its goal of tax harmony with our major trading partners.

3. World-Wide Apportionment Discriminates Against Foreign Companies Attempting to Establish Business Activities in the United States.

Foreign investment in the United States is a recent phenomenon, principally occurring during the past fifteen years. It is not a coincidence, therefore, that the complaints of our major trading partners have arisen in only the last few years. This coincides with the first use of world-wide apportionment by the State of California to significant foreign investment beginning only since the late 1960's.

The foreign trading partners believe world-wide apportionment discriminates against foreign investment in the United States, especially in the case of new products which are intended to compete in established markets. Even if the operations of the foreign company in the United States result in significant losses during the early years, world-wide apportionment will result in a substantial tax if such company makes an overall profit from its world-wide business activities. The foreign company is taxed at home without apportionment on all its income and taxed again by the States. U.S. multinational companies of comparable size to a foreign company and having comparable business activities within and without the United States normally will incur a smaller overall tax liability than the foreign company because they are taxed in the foreign country on the basis of separate accounting with respect to their profits earned within such foreign country. U.S. companies further benefit from the right to deduct state taxes paid for federal income tax purposes, deductions of little use to a foreign company sustaining losses in the United States. Accordingly, U.S.

companies established in the U.S. market enjoy a competitive advantage over newly entering foreign companies which initially earn little or no profit. World-wide apportionment results in duplicative taxation usually without the benefit of any tax credit for taxes paid either to the state or the foreign government.

Actual double taxation can be demonstrated by the circumstances presented by one of the Amici. Akai America, Inc. is a wholly-owned subsidiary of Akai Electric Co., Ltd., one of the Amici in this brief. For the period 1972 through 1975, Akai America, Inc. (hereinafter "Akai") experienced a combined net operating loss for federal income tax purposes of over $8,000,000. The losses resulted principally from difficulties in establishing a presence in the United States market and the competitive conditions of the electronics industry generally. The California Franchise Tax Board has assessed a tax for such years in an aggregate amount in excess of $135,000 based upon world-wide apportionment. World-wide income of Akai's parent was fully taxed without apportionment abroad. This circumstance is not unusual and will generally occur whenever a foreign company wishes to establish business operations in the United States. Simply put, a penalty tax will be exacted by world-wide apportionment in most startup circumstances involving profitable foreign multinational companies.

There is no mechanism on the international level to adjust disputes among countries except through bilateral and multilateral negotiations. Our major foreign trading partners simply do not like world-wide apportionment as imposed by the States when it results in obvious duplicative taxation of profits which, in their view, are earned solely from their efforts in their own country and in countries outside the United States.

Justice Stevens summarized the general rule against taxing extraterritorial income in his dissent in *Mobil Oil* by

quoting from a legal scholar and adding his comments as follows:[26]

> "The basic proposition can be simply stated: At least as far as nondomiciliary corporations are concerned, a state may only tax income arising from sources within the state. Or, put differently, it cannot give its income tax extraterritorial effect."
>
> To put it still differently, if, in a particular case, use of an allocation formula has the effect of taxing income earned by an interstate entity outside the State, it could alternatively be said to have the effect of taxing the income earned by that entity inside the State at a rate higher than that used for a comparable, wholly intrastate business, a discrimination that violates the Commerce Clause.

4. Economic Factors Are Not Substantially Equal Among the Nations, a Circumstance Which Results in Unreasonable Distortion in World-Wide Apportionment.

Justice Holmes' opinion in *Fargo v. Hart*, 193 U.S. 490 (1904) quoted in the dissent filed in *Mobil Oil*,[27] is relevant to put in perspective the circumstances in which the use of a combined return of a unitary business is appropriate:[28]

> It is obvious, however, that this notion of organic unity may be made a means of unlawfully taxing the privilege [of carrying on commerce among the states], or property outside the state, under the name of enhanced value or good will, if it is not closely confined to its true meaning. So long as it fairly may be assumed that the different parts of a line are about equal in

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[26]*Mobil Oil*, *supra* note 3, at 451 (quoting Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX. L. REV. 171, 181 (1970)).

[27]*Id.* at 454.

[28]*Fargo v. Hart*, 193 U.S. 490, 499-500 (1904).

> value, a division by mileage is justifiable. But it is recognized in the cases that if, for instance, a railroad company had terminals in one state equal in value to all the rest of the line through another, the latter state could not make use of the unity of the road to equalize the value of every mile. That would be taxing property outside the state under a pretense. (citations omitted)

Foreign trading partners perceive world-wide apportionment as unfair and discriminatory because the factors used for apportionment are not sufficiently uniform from country to country as they are from state to state. The same dollar value of property, sales and payroll in the United States produces a significantly different return compared with the value of such factors in foreign countries, especially with respect to foreign countries on the western rim of the Pacific. As Assistant ecretary of the Treasury for Tax Policy, Donald C. Lubick, stated in his 1980 testimony before a subcommittee of the Senate Finance Committee:[29]

> [W]ith the United States paying higher wages than is true in many other foreign countries, you are going to have a distorting effect on the formula. You are going to generate the attraction of more income to the States, and that operates rather unfairly.

In addition, higher political, social and economic risks in foreign countries are taken by businesses only if the rewards of profitability are higher. World-wide apportionment disregards such differences and, in the process, overstates income apportioned to a particular state.

This distortive effect is not confined to the wages or payroll factor. Since foreign investment is a relatively recent phenomenon, foreign investment in the United States is measured by the value of today's dollars. In California, the property factor is determined on the basis of historical cost

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[29] ***Hearings on State Taxation of Interstate Commerce and Worldwide Corporate Income***, *supra* note 14, at 40.

and not current fair market value.[30] As a consequence, under world-wide apportionment new investment is accorded a greater allocation of profit than old investment. California-based multinational companies which establish markets and invest in current dollar values outside the State of California enjoy benefits from the reciprocal of this distortion and further advantage themselves compared with new foreign investment in the state.

Newly established plants, especially in high technology areas, require several years before the plants can be operated at the same levels of productivity and profitability as plants previously built in foreign countries. World-wide apportionment, therefore, causes the investing foreign company to pay a penalty for investing in the United States in businesses which they support and control. The same penalty may occur whenever a foreign company acquires the assets of an existing U.S. company by merger or otherwise. In many cases, targets for such acquisitions are companies which are operating marginally or have losses based upon standard federal income tax rules. Solely as a result of the acquisition, the acquired company's tax liabilities to a state under world-wide apportionment would increase significantly. Nothing would have changed in the operations of the company, its mangement or in its levels of productivity or profitability.

5. Changes in Currency Conversion Rates Artificially and Unreasonably Affect the Amount of Tax Liabilities Determined Pursuant to World-Wide Apportionment.

In many instances, whether a company is liable to pay tax to a state pursuant to world-wide apportionment (and the exact amount of such liability) will depend solely upon

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[30]CALIF. REV. & TAX. CODE § 26422 (West 1979) and 18 Cal. Admin. Code Reg. 25130(a) (May 29, 1971) issued thereunder.

the rise or fall of rates at which a currency of one country is converted into a currency of another. These factors depend wholly on circumstances outside the context of activity which the foreign multinational or its affiliate entities have and are pursuing in the United States. The stronger the dollar is against a foreign country's currency the more the three factors in the formula will allocate world-wide profit to the taxing state. Thus, with respect to each factor in the formula, currency depreciation and appreciation will significantly affect the numbers in the calculation. On the other hand, a stronger foreign currency will overstate world-wide net income before tax of a foreign based multinational. A company doing business in twenty or more countries may find the currency inflated in the country in which profits are highest yet find the dollar stronger compared with the currencies of countries which have most of the property, payroll and/or sales. The vagaries of the calculation, the problems of currency translation in general, and the artificiality connected with the method for determining the tax liability of operations in the United States are readily apparent and result in serious distortions in the case of foreign companies.

U.S. based multinational companies face similar problems in preparing returns or combined reports to States. The difference between U.S. and foreign companies, however, is not only in the degree to which foreign multinationals have interests and operations outside the United States but also with respect to the quality of the accounting and financial information at their disposal. A combination of these circumstances presents totally unique problems to foreign multinational companies when attempting to comply with world-wide apportionment imposed by a state.

6. Conclusion.

The principles enunciated in *Japan Line* concerning the Foreign Commerce Clause should be extended to the States' taxation of foreign source income if the risk of duplicative

taxation exists[31] or if the burdens on foreign commerce are significant. The use of world-wide apportionment by the States results in duplicative taxation of foreign and domestic companies and unreasonably burdens foreign commerce. This method of taxation clearly is encroaching upon the interest of the Federal government in preserving tax harmony, tax simplification and avoidance of duplicative taxation with our trading partners.

The States have no role or interest in this area. The only proper concern or interest which the States have is raising revenue pursuant to their Constitutional rights to levy taxes. Ample means are at the disposal of the States to further this interest. In deciding this case, we respectfully urge the Court to consider the effect its decision will have under the Foreign Commerce Clause upon foreign companies which are engaging in trade with, or investing in, the United States.

Respectfully submitted,

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LILLICK MCHOSE & CHARLES,
Attorneys for Amici Curiae
The International Bankers
Association In California
Akai Electric Co., Ltd.

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[31] *See* P. Hartman, *Federal Limitations on State and Local Taxation* (1981) in which the author stated his conclusion with respect to this issue as follow:

> [W]here income from a a multinational business is taxable in a foreign country as well as by the States, it is somewhat difficult to escape the conclusion that some aspects of the rationale of *Japan Line* would be present, unless *Japan Line* is confined to the actual levy of a property tax on instrumentalities of foreign commerce. *Id.* at 560.

APPENDIX.

Ambasciata D'Italia
Washington, D.C.

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine EEC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.
March 19, 1980
To the Department of State, Washington, D.C.

UNITARY TAXATION

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries".

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty. Article 9 (4) of the Treaty, which was supported by the Administration, would have disallowed

the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9 (4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9 (4) was not to apply for the purpose of state taxation. Article 9 (4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress. S983, S1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Washington, D.C.
March 19, 1980

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November 10, 1981

HEADLINE: U.S. will be asked to end non-tariff barriers.

BODY: While the U.S. up to this time has been the one urging Japan to do away with so-called nontariff barriers, Japan now is going to submit a 14-point request asking the U.S. to do some removing on its own.

This was decided by the Japanese Government last week, and its "counter-demand" will list such as the following points as non-tariff barriers: 1) Administration of its trade system, such as its antidumping checkups; 2) Restriction in issuance of visas to Japanese company personnel; 3) the unitary tax system, such as practiced by the State of California.

So far, it has been the U.S. that has strongly done the criticizing, such as by citing Japan's import inspection system to be a non-tariff barrier.

The Japanese Government thus intends to submit its views to the U.S. during this month with the aim of obtaining a response from the U.S. side on the matter at the second meeting of the Japan-U.S. Trade Group, scheduled to be held in Tokyo from December 7 to 9.

The first topic it takes up is the anti-dumping investigation practice and the U.S. Government's administration of laws and regulations related to trading, such as tariff and trade laws.

This is because it is held that the U.S. Government's broad interpretation of laws has given cause to moves for ousting Japanese products on the alleged grounds of unfair competition.

One of the recent cases is considered to be the provisional judgment by the International Trade Commission in September that the contract won by Nippon Electric Co. for supplying Communications Satellite Corp. (COMSAT) with satellite communication equipment constituted a case of dumping.

The Japanese Government's feeling is that if the U.S. and its enterprises repeatedly raise suits against Japanese goods from an arbitrary interpretation of legalities, Japan's exports to the U.S. can be "frozen," commercial negotiations actually can be disrupted, and Japanese businesses may be called upon to submit such a voluminous amount of counterdata as to obstruct their daily work.

The 14-point request also considers the "Ship American" and "Buy American" policies as being typical non-tariff barriers as well that a problem exists, procedural or otherwise, as to the obligation of making a declaration on place of origin of a product, and manner of tariff classification.

As to the regulation specifying place of origin, the Government will point out that customs clearance often is withheld from such reasons as "lack of clarity" of the declaration, and some Japanese businesses even have given up exports to the U.S. of small items because of the difficulty of filling all of the data needed.

The Government also will cite as an example in the problem of tariff classification the case of polvethyene decorative hats. U.S. customs officials have been divided as to whether they should come under tariffs set for chemical products or for textile products.

Other "barriers" are regarded to be the unitary tax which provides for imposing an income tax on the earnings of the local enterprise together with the earnings of its parent firm.

Resolution for Urging an Abolition of the Unitary Tax Formula Based on World Wide Income.

by State Authorities of the United States of America

KEIDANREN (Federation of Economic Organizations, Japan)

December 8, 1981.

It is the common policy objective of nations to achieve their sound economic and social development through the maintenance and advancement of active international economic interchange. The activation of international investment and trade in recent years is a consequence of the efforts of governments and private business communities in many countries to remove impediments to economic exchange.

This trend is especially evident in Japanese-American economic relations. Their mutual understanding and cooperation have greatly advanced and have led to notable increases in direct investments by Japanese firms in the United States. The Japanese corporations which have established American subsidiaries have considerably benefitted the localities where they have found residence by way of increasing local employment, procurement of parts and components and investment funds. Further growth of direct Japanese investments in various regions of America is indispensable to the development of sound economic ties between Japan and the United States, a view commonly shared by government and business in both countries. It is important that continued efforts are steadfastly made to promote the two-way flow of direct investments.

Viewed in the light of these desirable developments, the extension of the unitary tax formula to foreign-owned businesses in the State of California and other states poses a serious impediment to direct Japanese investment in the U.S. It has become a major strain on business activities of

many Japanese corporations as well as their subsidiaries operating in the State of California. In the recent few years, a similar method of taxation began to be introduced in some other states, thereby causing serious concern among Japanese businesses which are planning to invest in the U.S.

There exists a general agreement among nations that the so-called the-arm's-length standard and independent party principles provide the most fair and adequate basis for apportioning the taxable income internationally. This is exemplified by the fact that "the Draft Double Taxation Convention on Income and Capital" by the Organization for Economic Cooperation and Development (OECD) is predicated on these principles. The global method of tax assessment, which includes foreign-source incomes as taxable income, cannot be accepted from the viewpoint of the OECD.

Extending the scope of application of the unitary tax formula to incomes generated outside the U.S. is a serious aberration from the internationally recognized norms of corporate income taxation. It is liable to result in double taxation and run into conflict with the widely accepted taxation principles as well. Such an unreasonable taxation policy is viewed with serious concern not only in Japan but also widely in the rest of the world.

As typified by the position of the National Association of Manufacturers, the American business community has also opposed for some time the application of the unitary tax formula to the off-shore incomes of U.S. enterprises and has demanded that it be abolished for the following reasons:

(1) The unitary tax formula distorts the internationally established principle, results in double taxation and hampers the active expansion by U.S. enterprises of their overseas operations;

(2) It is detrimental to the consistency of trade

policy and fairness of taxation for the United States, a federal entity, as provided under the U.S. Constitution.

It was pointed out in the Supplemental Report of the Japan-U.S. Economic Relations Group submitted in October 1981 to the Prime Minister of Japan and the President of the United States that "there are many sound reasons for terminating unitary taxation systems." The report further expressed hopes that "legislators on both the state and Federal level will take into consideration the deleterious effects (of such systems) on foreign investments." This opinion of the group is but one indication of the desire to see the abolition of the application of unitary tax formula to foreign source incomes commonly shared by those who desire the further growth of Japan-U.S. economic relations through increased investment flows.

From the considerations cited above and acting on the consensus of the Japanese business community, Keidanren strongly seeks abolition by the states concerned of the application of the unitary tax formula to foreign source incomes in the shared interest of sound development of Japan-U.S. economic relations. This organization thus transmits this resolution to the governments of Japan and the United States and to the United States Congress for appropriate disposition.

Resolution of the Council on Unitary Taxation.

We, the members of the Council on Unitary Taxation Issues[1] of Kansai Area, Japan, have met on this 10th day of December, 1981, and agreed that:

BACKGROUND OF THE UNITARY TAX PROBLEM

The so-called "Unitary Tax" (i.e., combined reporting with formula apportionment) levied on worldwide income by State Authorities of the United States, including the State of California, disregards existing national boundaries and different economic conditions and practices between Japan and the United States. Furthermore, such a method of taxation presumes unrealistically that a Japanese parent company and its subsidiary in the U.S. and other countries operate on the same profit level, in spite of different nationalities and business practices. Application of the Unitary

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[1]The Council on Unitary Taxation Issues of Kansai Area, Japan is comprised of 49 companies, all located in the Kansai area of Japan, who have formed an organization to consider and react to the imposition of California's Unitary Tax to their affiliated companies. The members of the Council are: Itoman and Co., Ltd., Iwatani Co., Ltd.; Osaka Transformer Co., Ltd.; Kanegafuchi Chemical Industry Co., Ltd.; Kawasaki Heavy Industries, Ltd.; Kansai Economic Federation; Kintetsu Department Store; Kyoto Chamber of Commerce and Industry; Kubota, Ltd.; Sanwa Bank, Ltd.; Sanyo Electric Co., Ltd.; Shimazu Corporation; Sharp Corporation; Shimpo Industrial Co., Ltd.; Shofu Dental Mfg. Company Ltd.; Sumitomo Metal Industries, Ltd.; Sumitomo Electric Industries, Ltd.; The Daiwa Bank, Ltd.; Takenaka Komuten Co., Ltd.; Omron Tateishi Electronics Company; Taiyo Co., Ltd.; Dainippon Screen Mfg. Co., Ltd.; Toyobo Co., Ltd.; The Tokai Bank Ltd.; Nissin Food Products Co., Ltd.; Nippon Sheet Glass Co., Ltd.; Nichicon Capacitor Ltd.; Hanwa Co., Ltd.; Hitachi Shipbuilding and Engineering Co., Ltd.; Horiba, Ltd.; Matsushita Electric Industrial Co., Ltd.; The Green Cross Corporation; Moon Bat Co., Ltd.; Wacoal Corp.; Wako Securities Co., Ltd.; Electronic Industries Association of Japan; Sanitory; Kanebo, Ltd.; Takeda Chemical Industries, Ltd.; Takashimaya Company, Ltd.; The Sumitomo Bank Ltd.; Sumitomo Mutual Life Insurance Company; The Taiyo Kobe Bank, Ltd.; Murata Manufacturing Company, Ltd.; Nippon Life Insurance Company; Kobe Steel, Ltd.; Daiwa House Industry Co., Ltd.; Teijin Limited; Koyo Seiko Co., Ltd.

Tax to Japanese parent companies is creating substantial distortion problems, unreasonable administrative burdens and significant misallocation of income.

SPECIFIC PROBLEMS WITH THE WORLDWIDE APPLICATION OF THE UNITARY TAX

We have discussed and indentified the following problems resulting from application of Unitary Tax on a worldwide basis:

1. By expanding its tax jurisdiction beyond state boundaries to Japan and other foreign countries, some States, including the State of California, which employ the Unitary Taxation method on a worldwide basis cause double taxation of income earned by Japanese parent corporations.

2. Without any reasonable grounds, States, including the State of California, which employ the Unitary Taxation method on a worldwide basis levy irrational taxes on income significantly different from that which Japanese subsidiaries in the States actually earned.

3. Japanese companies which have made direct and substantial investments in the U.S. to establish subsidiaries are burdened unnecessarily and excessively, in comparison with U.S. domestic companies, by the state imposed requirement of gathering, maintaining and supplying additional accounting

4. Application of the Unitary Tax on a worldwide basis poses a serious impediment to further Japanese investment in the United States, despite the fact that the United States is making a serious effort to promote such Japanese investment in the U.S.

RESOLUTION AND CONCERNS

Based on the problems listed above, we have agreed to oppose, in the most decisive manner, application of the Unitary Tax on a worldwide basis.

In addition, we are deeply concerned with the recent trend in the United States of additional states in the U.S. taking steps to apply the Unitary Taxation method on a worldwide basis to foreign companies.

Furthermore, we are concerned that nations of the developing countries may also begin to apply the Unitary Tax to foreign parent corporations. If the Unitary Taxation method prevails to such an extent, internationally accepted taxation principles will be disordered and, as a result, international trade and investment would be damaged.

RECOMMENDATIONS TO THE GOVERNMENTS OF JAPAN AND THE U.S.

With this resolution, we strongly urge the governments of Japan and the United States to take the following action:

1. Both governments should exert strong initiatives to lead all the states of the United States to adopt the so-called arm's-length principle for apportioning the taxable income of Japanese parent corporations and their U.S. subsidiaries. We believe that, as the U.S.-Japan tax treaty and the U.S. Federal tax law provide, the arm's-length standard is a fair and reasonable taxation method with respect to business transactions between Japan and the United States.

2. Both governments should take notice of the substantial impact which the Unitary Tax is having on bilateral trade and investment activities. The Japanese government should explicitly notify the U.S. government that, unless the unfairness imposed by the Unitary Tax is resolved, the Japanese government shall be concerned with a critical disruption of the bilateral investment relationship.

3. In close co-operation with Western European countries, which also object to the unfairness of the

Unitary Tax (applied on a worldwide basis), the Japanese government should consider raising the issue for discussion at a meeting of GATT.

CONCLUDING RECOMMENDATION TO JAPANESE BUSINESSES

Because of our grave concern with the inequitable nature of Unitary Taxation on our foreign investment activities, we, the members of the Committee on Unitary Taxation Issues in the Kansai area, earnestly appeal to the Japanese corporate decision makers to reconsider their foreign investment policies and make no further direct investment in the States of the United States which impose or are imposing a Unitary Tax on a worldwide basis.

United Kingdom

British Embassy
Washington, D.C. June 23, 1980

Hon. Harry F. Byrd. Jr.
Russell Senate Office Building
U.S. Senate, Washington, D.C.

My Dear Senator Byrd: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. Anson, Minister, Economics

(Press release issued by the British Embassy Information Department)

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US which was signed in London on 31 December 1975, and the three supplementary Protocol which were signed in London on 26 August 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9 (4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Governemnt and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. (*sic*) It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or

branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although (*sic*) the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of prof-

its between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organizations for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

February 15, 1977

Dear Mr. Huff:

Thank you for your letter of January 24, 1977 and the copy of your letter to Secretary Vance, concerning objections to paragraph 4 of Article 9 of the proposed income tax treaty with the United Kingdom.

I understand your concern over this provision, but I cannot agree, after careful review of the issue, that the provision should be withdrawn from Senate consideration. I support the objective of the provision and furthermore, I feel that the Senate should be given the opportunity to voice its opinion.

I am sure that the arguments in support of the provision are familiar to you, but I would like to summarize them briefly.

The scope of the provision is quite limited. It will restrict the ability of California to include foreign affiliated corporations of a corporation doing business in California, only when that corporation is controlled by a U.K. corporation (which is in turn controlled by British shareholders). I am aware, as you state in your letter, that this does provide limited preferential treatment for U.K. based multinational corporations. You must bear in mind, however, that a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom.

The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from

taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country. Under unitary apportionment, if the profit rate of the foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise.

Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The unitary system imposes a substantial compliance burden on multinational corporations. Much of the information required for a combined report with respect to a foreign parent or foreign sister corporation may not be available to the taxpayer. Even where the information is available, the burden of reporting the accounts of many far-flung affiliates on a standardized basis can be great. We are aware of cases where this burden has discouraged foreign investment in the United States.

For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable.

Sincerely yours,

/s/ W. Michael Blumenthal
W. Michael Blumenthal

Mr. Martin Huff
Executive Officer
California Franchise Tax Board
Sacramento, California 95867

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District.

BRIEF OF FRANK M. KEESLING AS AMICUS CURIAE IN SUPPORT OF APPELLEE.

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TABLE OF CONTENTS

Page

Interest of Amicus Curiae 1

The Issues 2

Argument 3

I.

During the Years in Question Appellant Was Engaged With Its Subsidiaries, Foreign as Well as Domestic in the Conduct of a Unitary Business 3

A. This Case Is Not Controlled by Woolworth . 3

B. Definition of a Unitary Business 3

C. Contributions of Appellant to the Functioning of the Foreign Subsidiaries 6

1. Financing 6

2. Furnishing Technical Services 6

3. Purchases of New Equipment 7

4. Sales of Used Equipment 8

5. Sales of Raw Materials 8

6. Appellant's Involvement in the Management and Accounting Practices of the Foreign Subsidiaries 9

7. Intercompany Transfer of Employees ... 10

8. Pension and Other Plans 11

9. Research 11

10. Major Policy Matters 11

11. Visits to United States by Officers and Employees of Foreign Subsidiaries 12

D. Non-Arm's-Length Charges 12

1. Loans and Guarantees of Loans 13

2. Purchases of New Equipment 14

3. Payments of Salaries to Employees on Subsidiaries' Payroll 15

Page

4. Charges for Technical Services 15
5. Reimbursement for the Salaries and Expenses of the Members of the Foreign Operations Staff 15

E. The Underlying Activity 16

II.

The Inclusion of Foreign Subsidiaries in a Combined Report Is Constitutional 19

A. Any Double Taxation of the Same Income Resulted From Overstatement of the Foreign Taxable Income 19

B. The Use of Different Methods of Apportioning Income Does Not Necessarily Result in Double Taxation 21

C. The Rationale of Japan Line Is Not Applicable Here 23

D. The Fact That Labor and Property Costs in Foreign Countries Are Lower Than in the United States Does Not Render the Combined Report Invalid 24

E. Restricting the Use of the Combined Report to Domestic Corporations Will Result in Widespread Tax Avoidance in Some Instances and in Excessive Taxation in Others 25

1. Tax Avoidance 25
2. Excessive Taxation 27

F. The Use of Separate Accounting Will Not Result in the Nation Speaking With One Voice 29

Conclusion 30

TABLE OF AUTHORITIES

Cases	Page
Butler Bros. v. McColgan, 17 Cal.2d 664 (1941), aff'd 315 U.S. 501 (1942)	3, 4, 8
Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 (1947)	4
Exxon Case, 90 Wisc.2d 700, 281 N.W.2d 94 (1979)	4
Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980)	5, 28
F.W. Woolworth Co. v. Taxation & Revenue Dept., ... U.S.	3, 6
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	23, 24
John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214 (1951)	24, 25
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980)	16, 23, 24
Peck & Co. v. Lowe, 247 U.S. 165 (1917)	23
Superior Oil Company v. Franchise Tax Board, 60 Cal.2d 406, 34 Cal.Rptr. 545 (1963)	5, 27
Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920)	18, 19

Constitution — Page

United States Constitution, Art. I, Sec. 9, cl. 5 23

Miscellaneous

Controller General's Report to the House Committee on Ways and Means (September 30, 1981) 30

Treatises

Altman, G. and F. Keesling, Allocation of Income in State Taxation, Ch. V, "Principles of Allocation of Business Income and Ch. VIII, "Apportionment of Income of Affiliated, Related, or Controlled Taxpayers" Commerce Clearing House, Inc., p. 101 (1946) (2d Ed. 1950) 4, 30

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

BRIEF OF FRANK M. KEESLING AS AMICUS CURIAE IN SUPPORT OF APPELLEE.

Interest of Amicus Curiae.

Both the Appellant and the Appellee have consented to the filing of this brief.

Amicus Curiae is not representing anyone in this matter. He has been interested in the problem of the allocation and apportionment of income for state tax purposes for nearly fifty years. As Counsel to the California Franchise Tax Commissioner (the predecessor of the California Franchise Tax Board) during the years 1935-1939, he made many contributions to the state's allocation and apportionment policies, including the one which is at issue herein, *i.e.*, the requirement for the filing of a combined report in instances where two or more commonly owned corporations are engaged in the conduct of a unitary business partly within and partly without the State of California. He has written and lectured on this subject fairly extensively.

The Issues.

During the years involved herein, *i.e.*, 1963, 1964 and 1965, Appellant, a domestic corporation, was engaged in the manufacture and sale of containers in various states of the United States, including the State of California. It acknowledges that this business was unitary in nature, and that the income attributable to the various states may properly be computed by the use of an appropriate apportionment formula rather than by separate accounting.

During the same years Appellant owned all of the stock of various foreign corporations, and a controlling stock interest in various other foreign corporations, all of which were engaged in the manufacture and sale of containers outside the United States. The businesses of the foreign corporations were similar to the business of the Appellant in the United States but varied somewhat due to different market demands.

Appellant contends that the foreign subsidiaries were engaged in the conduct of separate and discrete businesses, and that the income therefrom was properly computed by the separate accounting method and that none of such income was attributable to sources in California or to any other state.

Appellant further contends that even if it should be held that the Appellant and the foreign subsidiaries were engaged in the conduct of a unitary business partly within and partly without the State of California, it is unconstitutional, for a number of reasons, to include the income of the foreign corporations in a combined report.

ARGUMENT.

I.

DURING THE YEARS IN QUESTION APPELLANT WAS ENGAGED WITH ITS SUBSIDIARIES, FOREIGN AS WELL AS DOMESTIC IN THE CONDUCT OF A UNITARY BUSINESS.

A. This Case Is Not Controlled by Woolworth.

Appellant states that the facts in the instant case are strikingly similar to those in *F. W. Woolworth Co. v. Taxation & Revenue Dept.*, ... U.S. .... . (App's. Br. 10.) This is simply not true. In fact, it would be more accurate to say that the facts in the instant case are strikingly different than those in *Woolworth*. Although there are similarities such as common ownership of the subsidiaries, there are many elements of unity in the instant case which were not present in *Woolworth*. They will be referred to and discussed below.

Appellant contends that for a business to be unitary there must be a continuous flow of goods between the different taxing jurisdictions in which the business is conducted. (App's. Br. 41.) This is wishful thinking on Appellant's part. *Woolworth* and other cases cited by Appellant simply do not support this contention. The opinion in *Woolworth* clearly recognizes that in determining the existence of a unitary business, such matters as common management, centralized performance of various functions and economies of scale may be considered.

B. Definition of a Unitary Business.

The real test of a unitary business is whether the operations within the state make substantial contributions to the functioning of the business as a whole. If so, and if the entire business is profitable, then some portion of the total income should be attributed to the operations within the taxing state. This can be accomplished by the application of the formula method which the separate accounting method often fails to do. This is fully established by *Butler*

Bros. v. McColgan, 17 Cal.2d 664 (1941), aff'd 315 U.S. 501 (1942).

Butler Bros. operated seven wholesale department stores located in as many different states. The business was managed and controlled from executive offices in Chicago, where the goods for all seven stores were centrally purchased. Although the business as a whole produced a substantial profit, Butler Bros. reported that a substantial loss was sustained by its California store.

It was stipulated that by buying in large quantities, the company was able to achieve a purchasing profit. It was able to buy in large quantities only because it sold in large quantities. The California store contributed to the sales, and in so doing helped the company obtain a purchasing profit which was beneficial to the business as a whole. Both the California Supreme Court and this Court held that the business was unitary and that it was permissible for California to attribute a portion of the total income to the state by the application of the three factor formula of property, payroll and sales.

A unitary business has been defined as one where there is a relationship of dependency or contribution between the portion of the business within the taxing state and the portion of the business outside such state. G. Altman and F. Keesling, *Allocation of Income in State Taxation*, 101 (1946); (2d Ed. 1950).

The foregoing definition of a unitary business was approved by the California Supreme Court in *Edison California Stores, Inc. v. McColgan*, 30 Cal.2d 472 (1947). From there it has spread all over the country, and has been frequently cited in briefs, law review articles and opinions of appellate courts, including the Supreme Courts of many states. For a comparatively recent example, *see* the opinion of the Wisconsin Supreme Court in the *Exxon* case, 90 Wisc.2d 700, 281 N.W.2d 94 (1979). In that opinion, the Wisconsin Supreme Court quoted in full the dependency or

contribution definition of a unitary business as set forth in the above-referred to treatise. *See also*, this Court's opinion in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1931).

Where there is trade between different taxing jurisdictions, *e.g.*, where a corporation manufactures goods in one state and the goods are sold by it or by affiliated corporations in other states, it is clear that the manufacturing and selling operations complement one another, and each makes a substantial—even essential contribution to the overall enterprise. But even where there is no such trade, a business conducted in several jurisdictions may still be unitary. For example, a corporation operates a mine in state B. The ore extracted there is processed there, and the metal obtained is sold there. The business is managed and controlled from executive offices maintained in state A. Again, these operations complement one another, and each makes substantial contributions to the functioning of the business as a whole. The business is accordingly unitary, and the income should be apportioned by formula. *See* Keesling and Warren, *The Unitary Concept in the Allocation of Income*, Hastings L.J. Vol. 12, No. 1, 42, 50 (1960).

The conclusion that a business may be unitary even though there is no trade between different jurisdictions in which the business is conducted is fully supported by *Superior Oil Company v. Franchise Tax Board*, 60 Cal.2d 406, 34 Cal.Rptr. 545 (1963). Superior Oil Company was what is known as a non-integrated oil company. It explored for, drilled for and extracted oil but did not refine the oil or sell refined products in different states as in the case of integrated companies. Instead, all of the oil produced in a given state was sold at the well where produced. It was engaged extensively in the production and sale of oil in California as well as other states. Although the Franchise Tax Board is noted for the use of the formula method, in this case it believed that the operations in the different states

were sufficiently separate so that the income could be computed by the separate accounting method rather than by formula. The California Supreme Court, however, held otherwise and required that the formula method be employed largely because of extensive common management in California.

C. Contributions of Appellant to the Functioning of the Foreign Subsidiaries.

During the years in question, Appellant made numerous contributions to the operation of the foreign subsidiaries which were not present in the case of *Woolworth*. These contributions include the following:

1. Financing.

Unlike *Woolworth*, Appellant provided substantial financing to the foreign subsidiaries. This is an important factor in determining whether a business is unitary or separate. There were outstanding loans of several million dollars at the end of each year in question. JA 69 Stip ¶ 133. In addition, Appellant guaranteed a substantial amount of loans made by local lenders. JA 70 Last sentence of Stip ¶ 133.

In the aggregate, the loans made by Appellant and the loans guaranteed by it amounted to approximately 60% of the financing required by the subsidiaries. It is possible—even probable that the remaining 40% of the subsidiaries' financing requirements could not have been obtained from other sources were it not for the fact of Appellant's loans and guarantees. Thus it may well be that directly or indirectly, Appellant was responsible for the entire amount of financing required by the subsidiaries without which they could not have functioned.

2. Furnishing Technical Services.

The Appellant entered into agreements with six of the foreign subsidiaries, pursuant to which it agreed to furnish technical services to them. JA 74 Stip ¶ 144. (The agree-

ments are reproduced as Exhibit F to the Stipulation of Facts).

The agreements provided that Appellant would provide advice and consultation to each of the six subsidiaries concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting.

Some of the agreements refer to the fact that Appellant has been engaged in the production of containers for a long period of time and has accumulated much valuable experience which it agrees to make available to the six subsidiaries.

Appellant did not have a technical service agreement with the Colombia or Venezuela subsidiaries, since such agreements are not allowed by these countries. JA 74 Stip ¶ 144. Appellant did, however, provide such technical service to these subsidiaries.

The phrase "technical services" is a synonym for "know-how," for which American business is famous throughout the world. The furnishing of such service was undoubtedly of great value to the subsidiaries to which furnished, and strongly indicates that the businesses of Appellant and its subsidiaries were unitary—not separate in character.

3. Purchases of New Equipment.

Appellant arranged for the purchase of substantial quantities ($5 to 7 million dollars per year) of new equipment for the use of the subsidiaries. JA 77 Stip ¶ 148. Such equipment was purchased for the most part in the United States where Appellant functioned. Each subsidiary would perform its own engineering studies and submit its specifications to Appellant's purchasing department which would then locate the desired equipment, order it and arrange for its shipment to the subsidiary desiring it.

This function of purchasing equipment is very similar to the function performed by Butler Bros. headquarters office in purchasing goods for its seven wholesale houses. The

principal difference is that the goods purchased by Butler Bros. were purchased for resale by the seven divisions, whereas in the instant case the equipment purchased was purchased for use by the subsidiaries.

Furthermore, as in *Butler Bros.*, it is highly probable that by buying the equipment centrally in large quantities, substantially lower prices were obtained than would have been if each subsidiary had purchased its own equipment separately. Because of the centralized purchasing and the obtaining of a purchasing profit, Butler Bros. was held to have been engaged in a unitary business. A similar conclusion should be reached here.

4. Sales of Used Equipment.

From time to time Appellant would sell to the subsidiaries used equipment which was still in good condition but which was no longer suitable for the requirements of the Appellant bacause of its low capacity or because it was designed for a process no longer used domestically. JA 76 Stip ¶ 147. From the standpoint of the Appellant, it was certainly convenient to have a ready market for its obsolete equipment, and from the standpoint of the purchasing subsidiaries, it was certainly of considerable benefit to be able to purchase useable equipment at a low cost.

5. Sales of Raw Materials.

During each of the years involved Appellant made sales of raw materials to nearly all of the foreign subsidiaries. JA 73 Stip ¶ 141. These sales averaged over one million dollars per year. (Ex. A-8) In addition, Appellant purchased paper and resold it to the subsidiaries. According to this Stipulation, the amounts of such purchases are not available for the three years in question. However, for the three subsequent years, such purchases of paper averaged approximately six million dollars per year. JA 74 Stip ¶ 143. It is possible that the sales of paper amounted to a lesser figure during the years in question. Since the sales of paper for

the year 1966, the closest year to the years in question, amounted to $3,800,000.00, it is reasonable to assume that the sales during the three years in question may have averaged as much as three million per year.

If the sales of paper are added to the sales of other raw materials, a figure of four million dollars is obtained. This represents approximately 5% of the purchases of raw materials made by the subsidiaries. Obviously, this is another significant element of unity.

6. Appellant's Involvement in the Management and Accounting Practices of the Foreign Subsidiaries.

During the years involved Appellant maintained a Foreign Operations Staff consisting of two full-time officers, one part-time senior executive, one part-time controller and one part-time lawyer. JA 65 Stip ¶ 126.

A Mr. Green, Senior Vice President of Overseas Operations, spent approximately 40% of his time on overseas work, a portion of which was handling Appellant's international legal affairs. JA 65 Stip ¶ 127.

A Mr. Lennert Ulvaeus was employed by the Appellant in 1948. In 1963 he was promoted to Vice President of European Operations. JA 66 Stip ¶ 128.

Earl Kaufman, who had held a number of positions with the Appellant since 1933, was named Vice President of Latin American Operations in 1963. He had responsibility for all Latin American operations, which included 25 plants in three countries. Both of these men received remuneration from Appellant and also from a foreign subsidiary. JA 66 Stip ¶ 128.

It was stipulated that Appellant did not dominate the operations of the subsidiaries. Instead, Appellant's policies were to reach decisions by mutual understanding. In addition, it is stipulated that Appellant held local management strictly responsible for its performance. JA 167 Stip ¶ 130.

In addition to Mr. Green, Mr. Ulvaeus and Mr. Kaufman, five other of Appellant's officers were directors of one or more of the subsidiaries. JA 68 Stip ¶ 131.

Appellant required each of the subsidiaries to submit its budgets to it for informational purposes. JA 70 Stip ¶ 134.

Appellant also required each subsidiary to furnish it with monthly financial statements. At the year end more detailed financial statements were required.

Appellant also was involved in the development of the subsidiaries' accounting procedures such as development of formats for the transfer of information to the United States. Such information was needed, not only for the preparation of reports required by the federal government, but also to monitor the performance of the subsidiaries. JA 71 Stip ¶ 136.

All of the above-described matters indicate an involvement by the Appellant with the foreign subsidiaries which would not have occurred if the foreign subsidiaries were separate and independent corporations.

7. Intercompany Transfer of Employees.

During the years in question, 26 officers or employees of Appellant were transferred to one or more of the foreign subsidiaries. The names of such individuals and the positions to which they transferred are set forth in Exhibit D.

In an attempt to denigrate the importance of such transfers, Appellant compares the number of transfers to the total number of its employees in the United States and to the total number of the subsidiaries' employees. (App's. Br. 6.) Such a comparison is completely irrelevant. The individuals transferred were not to perform routine tasks. Instead, they were transferred to perform either executive or managerial services at a very high level. The proper comparison should have been with the total number of individuals employed by the foreign subsidiaries performing similar managerial or executive functions. If such a comparison had

been made, the number of individuals transferred would gain substantial added significance.

It should also be noted that these individuals while employed by Appellant had the opportunity to become quite familiar with various aspects of Appellant's manufacturing operations. This knowledge or "know-how" not possessed by other individuals employed directly by foreign subsidiaries was undoubtedly of invaluable assistance to the foreign subsidiaries.

8. Pension and Other Plans.

It is stipulated that the 26 individuals transferred to foreign subsidiaries remained on the payroll of the Appellant. They continued to receive all employee benefits except participation in the common stock bonus plan. JA 65 Stip ¶ 124(c). Thus, they continued to participate in Appellant's pension plan, retirement plan, and life insurance plan. Obviously, such arrangements would not be made between truly independent entities.

9. Research.

Appellant actively engages in extensive product research, design and market research. During the years in question, approximately 250 people were directly involved in these activities at an annual cost of approximately 4 to 5 million dollars. JA 27 Stip ¶ 56.

Although it is not so stipulated, it is reasonable to assume that the benefits of such research would be shared with Appellant's foreign subsidiaries.

10. Major Policy Matters.

Day to day management decisions were made by the management personnel in the foreign countries. However, most major policy matters, although initiated by foreign subsidiaries, were generally subject to review by Appellant. JA 39 Stip ¶ 74. (App's. Br. 4.)

11. Visits to United States by Officers and Employees of Foreign Subsidiaries.

Although Appellant did not maintain a training program for foreign subsidiary employees, there were approximately 10-12 visits per year for two six-week periods by foreign employees to learn about Appellant's methods of operation. Most visits were by one person at a time, although occasionally two or three people may have visited at one time. Some of the visitors were in control functions—others were plant managers. JA 69 Stip ¶ 132.

As noted above, during the years in question Appellant performed a great many services for the foreign subsidiaries. For the most part, when charges were made at all, the charges were in an amount calculated only to reimburse Appellant for its out-of-pocket expenses in order that it might break even. Independent businesses, however, are not operated on a break even basis,. Instead, the objective of independent businesses is to make a substantial profit over and above the necessary expenditures. If this policy had been pursued with respect to the subsidiaries, the charges would have been increased substantially with the result that the net income of the foreign subsidiaries would have been reduced and the domestic income would have been substantially increased.

D. Non-Arm's-Length Charges.

Appellant contends that the foreign subsidiaries were engaged in the operation of separate, discrete businesses. Its actions, however, belie this contention.

In the following matters, Appellant did not deal with the foreign subsidiaries on an arm's length basis, but instead grossly undercharged for the assistance and services rendered the subsidiaries:

1. Loans and Guarantees of Loans.

During the years in question, Appellant made substantial loans to the subsidiaries. At the end of each year the outstanding loans were as follows:

1963	$7,704,908.00
1964	7,155,714.00
1965	3,223,371.00

It is possible that additional loans may have been made during each year but repaid before the end of the year. (App's. Br. 2 N 1.)

Appellant also guaranteed loans to the subsidiaries by other lenders in substantial amounts, possibly two or three million dollars or more. JA 69-70 Stip ¶ 133. The reference to guarantees is in the last sentence of Stip ¶ 133.

Strange as it may be, there is no reference in either the Stipulation of Facts or in Appellant's brief as to the amount of interest charged on the above loans either long term or short term. However, in the 2952 forms which Appellant filed with the United States with respect to each subsidiary each year, there is an indication that some of the subsidiaries did make interest payments to Appellant. It is not certain whether these payments were made on the long term loans from the parent or the short term loans or on some other type of indebtedness. The amounts of such payments in the aggregate made by all of the subsidiaries for each year were as follows:

1963	$ 19,900.00
1964	95,000.00
1965	59,500.00
TOTAL	$174,400.00

These interest payments might have been adequate on loan advances during each year and repaid during such year, the amounts of which are not set forth in the Stipulation. But if they were intended as payments on the long term loans, the amounts of which are set forth above, they are

hopelessly inadequate. They are far less than what a domestic bank would charge for similar loans and guarantees in the case of an established and highly successful domestic corporation. Assuming that a domestic investor could be found that would be willing to make substantial long term loans to foreign corporations operating in foreign countries, it is certain that the charges would have been much greater than in the case of loans to established successful domestic corporations such as Appellant. There would also have been substantial charges for the loan guarantees.

Thus, it is abundantly clear that Appellant undercharged the subsidiaries in a very substantial amount for interest on loans and loan guarantees.

2. Purchases of New Equipment.

The foreign subsidiaries were also substantially undercharged for the purchase of new equipment.

As noted previously, such purchases amounted to between five and seven million dollars, plus 5% as a brokerage commission and acknowledges that if this function had been performed by independent brokers, the commissions they would charge would probably be somewhat higher. This is a substantial understatement. JA 77 Stip ¶ 148.

Independent companies would not have performed this function advancing the purchase price and assuming the risks of recovery from foreign corporations for a commission anywhere near to 5%. In fact, it is questionable whether such a commission would even cover the out-of-pocket expenses computed in accordance with good accounting practices, which would have taken into account the time and salaries of individuals in checking the specifications from the subsidiaries, locating the equipment, bargaining for the price, arranging for shipment, expenses of secretaries, telephone cost and various other items of overhead.

3. Payments of Salaries to Employees on Subsidiaries' Payroll.

As noted above, 26 of Appellant's employees were transferred to the foreign subsidiaries. These individuals continued to be carried on Appellant's payroll. Although Appellant was reimbursed for the salaries, there is nothing in the Stipulation to indicate that Appellant was reimbursed for the cost of continuing these individuals in various pension, retirement and insurance plans. An independent corporation operating at arm's length would not and could not make such an arrangement.

4. Charges for Technical Services.

The Appellant charged the foreign subsidiaries fairly substantial amounts for providing technical services. These amounts were as follows: JA 75 Stip ¶ 145.

1963	$179,985.00
1964	591,192.00
1965	587,650.00

These charges are large enough to indicate that the furnishing of technical services to the subsidiaries was an important matter and must have required the services of a large number of Appellant's personnel. There is, however, nothing in the record to indicate whether these charges were in excess of the cost of Appellant, equal to such costs or less than such costs. In view of the practice of Appellant in other matters, it would be surprising if these charges were substantially in excess of cost.

5. Reimbursement for the Salaries and Expenses of the Members of the Foreign Operations Staff.

The Foreign Operations Staff consisted of two full-time operations officers and three part-time officers. One of the part-time officers was a Mr. Green who devoted 40% of his time to matters relating to the foreign subsidiaries, including legal services. With respect to the two full-time officers and Mr. Green, there is nothing in the Stipulation of Facts to

indicate that Appellant was reimbursed either for the salaries paid to these individuals or for incidental overhead expenses such as salaries of secretaries and clerical assistants and general overhead incurred in the maintenance of offices. Two of the part-time officers were carried on both Appellant's payroll and the payroll of one of the subsidiaries. It is not indicated how the salaries were apportioned between these corporations.

Presumably all five of the members of the Foreign Operations Staff were members of Appellant's employee benefit plans such as the stock bonus plan, the pension plan, the retirement plan and the group insurance plan. Presumably Appellant was not reimbursed for the contributions to these plans on behalf of the above five individuals.

E. The Underlying Activity.

The determination as to whether a business is unitary should not be made on the basis of corporate forms, but should instead be made on the basis of the underlying activity. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 440 (1980). This is the philosophy of the combined report. *See* Keesling and Warren, Hastings L.J., Vol. 12, No. 1, 42, 57 (1960) wherein it is stated:

> "In any case where a business would be considered unitary if conducted by one taxpayer, it should likewise be so considered even though conducted by two or more affiliated corporations. Just as a state may look beyond its borders and take into account the entire income of a business in arriving at a determination of the amount of income reasonably attributable to the activities conducted within the state, so in the case of a group of affiliated corporations engaged in the conduct of a business, it may look at the total income of the group to determine the amount of income attributable to the portion of the business conducted within the state by one or more of the members of the group."

When one looks at the underlying activity, it appears that Appellant was incorporated in Delaware in 1926. It took over an existing business which was engaged in the manufacture of containers. Appellant actively continued in this business and expanded the business in the United States to a substantial extent. JA 13 Stip ¶ 22.

After concluding that the supplying of containers to meet the demands of foreign markets might be profitable, Appellant in 1944 extended its business to Colombia and Mexico. The business was further extended to Venezuela, Italy, Holland, Germany and Austria in subsequent years. JA 14 Stip ¶ 25.

Instead of endeavoring to supply the foreign markets with containers manufactured in the United States, it decided to operate plants in the various foreign countries for the following reasons:

1. To avoid the cost of transporting finished products which, in view of the weight of containers, would be very expensive;
2. To avoid import restrictions in various foreign countries; and
3. To obtain the benefits of somewhat lesser cost of labor and property in the foreign countries than those prevailing in the United States.

Except for a few individuals transferred from Appellant, the manufacturing and selling activities in the foreign countries were performed by residents of such countries. Undoubtedly the manufacturing and selling activities in the foreign countries greatly contributed to the success of the portions of the business operated in such countries, and, accordingly, greatly contributed to the earning of income. The services and activities of the Appellant with respect to the foreign operations also contributed greatly to their success and to the earning of income. Thus, these complement one another in the production of a common income. It is

impossible to determine separately and specifically how much income each of the respective activities contributed.

The factual situation here is somewhat reminiscent of that in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). The Underwood Typewriter Company manufactured a product in Connecticut which is sold partly there and partly in various other states. The product was charged out to the selling divisions at cost with the result that none of the fairly substantial income of the company was attributed to the manufacturing operations. The selling activities in the different states undoubtedly made substantial—even essential contributions to the earning of the company's income. A similar statement may be made with respect to the manufacturing operations in Connecticut.

This Court held that it was impossible to determine "separately" and "specifically" how much of the total income was attributable to the operations in the respective states. Therefore, it upheld the use of an apportionment formula which attributed 47% of the company's income to Connecticut. A similar result should be obtained here, and for the same reasons.

The value of Appellant's contributions to the foreign operations may be more fully appreciated if consideration is given to the question, What would have happened to such operations if Appellant had not made the contributions it did? Suppose there were no lending of funds, no transfer of knowledge gained from long experience in the production and sale of containers, no purchasing of equipment for the foreign operations, no transfer of raw materials and no transfer of employees to perform executive functions in the foreign countries? Without such contributions, it is probable that the foreign operations would have been unsuccessful. Thus, it may well be that the contributions made by Appellant like the contributions made in the foreign countries were essential to the success of the joint enterprise.

It is true that in *Underwood* there was a flow of goods across state lines. That, however, is not particularly important in determining how income should be apportioned. The important consideration is that functions or activities performed in different jurisdictions complement one another in contributing to a common income and that the amount contributed by each cannot be separately determined.

II.

THE INCLUSION OF FOREIGN SUBSIDIARIES IN A COMBINED REPORT IS CONSTITUTIONAL.

A. Any Double Taxation of the Same Income Resulted From Overstatement of the Foreign Taxable Income.

Income taxes imposed by foreign countries are generally substantially less than those in the United States. Some countries do not impose such taxes—others are imposed at a lower rate than those prevailing in the United States, and in still other countries the administration is so lax that many taxpayers either do not file returns at all, or file returns greatly understating the correct taxable income.

Under these circumstances, there is a great temptation to corporations with extensive business operations here and which also own a number of foreign subsidiaries to undercharge the foreign subsidiaries for various services performed for them, and instead to deduct the cost of such services in the computation of their federal taxable income and in the computation of the taxable income of various states. By this means the foreign taxable income may be substantially increased but the taxable income in the United States will be substantially decreased. Inasmuch as the income in this country is taxed at substantially higher rates than is applicable to the foreign income, substantial "savings" may be effected.

The tax benefits which may be obtained by either not charging foreign subsidiaries for various expenses incurred on their behalf or by understating such charges may be

illustrated by a simple example. X corporation is the parent of a large number of subsidiaries, both domestic and foreign. It owns a 40-story office building in New York which it uses in supervising and servicing both the domestic and foreign subsidiaries. Several hundred employees are engaged in this activity. Although a few of the employees may devote all of their time to either the domestic or the foreign subsidiaries, in the majority of instances, their time is devoted partly to each.

X performs numerous services on behalf of both the domestic and foreign subsidiaries, including advertising, auditing, legal, research, preparation of tax returns or advising with respect to tax matters.

A substantial part of the cost of the office building used by X, which includes depreciation, property taxes and various other maintenance expenses, should be charged against the foreign subsidiaries. There should likewise be charged against the subsidiaries a substantial portion of the salaries of the individuals who work part or full-time on behalf of the foreign subsidiaries.

X corporation decides not to make such charges, since such charges will serve only to reduce foreign income taxes which are imposed at a relatively lower rate—perhaps an average rate of 25% or less. Instead, it files a consolidated federal return with its domestic subsidiaries and deducts the full amount of all such charges in computing its federal taxable income which is taxed at a rate of approximately 50%. Thus, it reduces the overall income tax burden applicable to it and its subsidiaries by substantial amounts. Similar reductions are obtained in the same manner in the income taxes of many states in which the domestic subsidiaries operate.

Of course, the X corporation runs the risk that upon audit, the Internal Revenue Service or the auditing departments of various states may disallow some of the deductions on the grounds that they should have been charged to the for-

eign subsidiaries. However, the odds against that occurring are very good. The returns do not get audited every year. Furthermore, in view of X corporation's total domestic income, the expenses, including those attributed to the foreign subsidiaries, appear to be reasonable in amount, and, accordingly, are not apt to be questioned.

Appellant undercharged its subsidiaries and obtained tax benefits similar to those obtained by corporation X. If Appellant had dealt with its subsidiaries on a genuine arm's length basis and had charged the subsidiaries either an amount which it would have charged truly independent corporations, or had charged the subsidiaries an amount which a truly independent corporation would have charged its subsidiaries, the charges would have been much greater than the amounts actually charged. If such arm's length charges had been made, its taxable income for federal and state tax purposes would have been substantially increased, and the taxable income of the foreign subsidiaries would have been substantially decreased.

By undercharging the foreign subsidiaries, their taxable income and their foreign taxes were increased but at the same time the Appellant's domestic income and domestic taxes, both federal and state, were reduced by substantially larger amounts. Furthermore, as an added bonus, when the foreign subsidiaries declared dividends to the Appellant, the Appellant was able to claim credit not only for the correct amount of foreign taxes, but for the excess taxes as well.

In view of the foregoing, Appellant clearly has no grounds for complaining of double taxation.

B. The Use of Different Methods of Apportioning Income Does Not Necessarily Result in Double Taxation.

Appellant contends that the use by the states of the formula method to apportion worldwide income, whereas foreign countries use the separate accounting method, neces-

sarily results in double taxation of the same income. It is possible that a case resulting in double taxation will arise, but judged by experience of the past, such instances are apt to be quite rare.

The various states of the United States have imposed taxes on or measured by corporate income for over 60 years. There has never been a time when all of the states employed the same apportionment methods. In the earlier days some of the states employed one or the other of various formulae, but until comparatively recently, many of the states permitted or even required the use of separate accounting.

Now all of the states employ some type of formula for apportioning the income of a single corporate unitary business. The formulae used differ substantially. Most of the states use the three factors of property, payroll and sales as does California. Some, however, use a formula consisting of property, manufacturing costs and sales. This results in favoring states where manufacturing operations are carried on. One state, Iowa, uses a formula consisting of the single factor of sales. Colorado grants taxpayers an option. They may either employ a two factor formula of property and sales or the three factor formula of property, payroll and sales. Several states have recently given extra weight to the property factor, which, again, usually favors the state where manufacturing operations are carried on in which there is apt to be a large amount of property.

In 1936 California instituted the combined report. Shortly thereafter it was adopted by Oregon and Alaska and by a number of other states in subsequent years. It is now employed by approximately one-third of the 45 states which tax corporations on or measured by income. The other two-thirds of the states still permit or require the use of separate accounting to apportion income from transactions between affiliated corporations.

If, as Appellant claims, the use of different methods of apportioning income by different taxing jurisdictions nec-

essarily results in double taxation, one might expect there would be a number of cases so holding. However, so far as is known, there are no such cases. One might reasonably infer therefore that double taxation resulting from the use of different apportionment methods is not a serious problem. It is difficult to see why it would be any more serious in cases where the income of foreign corporations is included in a combined report. For further discussion of this subject, *see* Keesling, *The Combined Report and Worldwide Businesses*, TAXES—The Tax Magazine, April, 1982, 304, 307.

C. The Rationale of *Japan Line* Is Not Applicable Here.

Throughout its brief, Appellant assumes that the principle of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), a property tax case, should be extended to the corporate income tax field. A similar assumption was made in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 448 (1981). This Court repudiated this assumption as follows:

> "Appellant's attempted analogy between this case and Japan Line strikes us as forced. That case involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax."

In *Peck & Co. v. Lowe*, 247 U.S. 165 (1917) this Court held that a tax on income from exports was not a tax on exports in violation of Art. I, Sec. 9, Cl. 5 of the United States Constitution which prohibits Congress from levying a tax on exports. One of the reasons for this holding was that the tax arises after the exportation is completed.

Similarly, it may well be urged that a tax on income from commerce is not a tax on commerce. *See*, Keesling, *The*

Impact of the Mobil Case on the Apportionment of Income, Brigham Young University L.R., 96 (1981) wherein it is urged that *Japan Line* should not be applied to the income tax field for reasons similar to those advanced by this Court in *Mobil*. It was further stated that if *Japan Line* is extended to the income tax field, it should be limited to instances where a foreign corporation is taxed by a foreign country on its entire worldwide income and is also taxed on a portion of the income by one of the states. It should have no application in cases such as the instant one where the parent corporation is a domestic company.

One of the reasons for this Court striking down the tax imposed by the County of Los Angeles upon a portion of the movable property owned by *Japan Line* which had been taxed by Japan upon its entire worldwide movable property was to prevent the possibility of recrimination. In instances, such as the present one, where the parent corporation is a domestic company, there is no substantial likelihood of recrimination. Foreign countries could care less how the states of the United States tax domestic companies.

D. The Fact That Labor and Property Costs in Foreign Countries Are Lower Than in the United States Does Not Render the Combined Report Invalid.

Appellant cites statistics indicating that labor and property costs in foreign countries are substantially lower than in the United States. It then argues that the use of the formula method which the combined report makes applicable to apportioning the income of two or more affiliated corporations engaged in the conduct of a unitary business, results in the taxation of income earned in foreign countries. (App's. Br. 12.)

The Court's attention is called to the case of *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal.2d 214 (1951) where a similar argument was made. The taxpayer intro-

duced evidence to the effect that wage rates in California were 50% higher than the national average, and that property values in California were very substantially nigher than in the national average. It argued that the use of a formula which includes the factors of property and payroll necessarily results in the taxation of income earned in other states. The California Supreme Court rejected the argument and upheld the use of the formula method on the ground that it is a reasonable method for the apportionment of income, and is not arbitrary or capricious simply because it includes factors which may deviate somewhat from the average.

It is recognized that the formula method does not result in a precise answer but only an approximation of the amount of income earned in any one jurisdiction. Accordingly, it should be used only in cases, such as the instant case, where a precise answer cannot be obtained. Keesling, *The Combined Report and Worldwide Businesses*, TAXES—The Tax Magazine, April, 1982, 306.

Furthermore, in the apportionment of the income of a unitary business, the use of the formula method is far preferable to the use of separate accounting, the use of which would constitute an attempt to separate the inseparable.

E. Restricting the Use of the Combined Report to Domestic Corporations Will Result in Widespread Tax Avoidance in Some Instances and in Excessive Taxation in Others.

1. Tax Avoidance.

Appellant acknowledges that its domestic business is unitary, and, further, that it is permissible for the states to use the combined report in apportioning the income of domestic corporations engaged in the conduct of a unitary business. It insists, however, that the income of an affiliated foreign corporation should not be included even though its income is derived from a unitary business conducted in part in the United States. If such a rule were adopted, corpo-

rations doing business in the United States could avoid state income taxes with impunity by selling their goods to foreign subsidiaries at cost or a very low markup. The factual situation which gave rise to the combined report is illustrative. A number of California corporations which were engaged in very profitable businesses sold their product at cost to wholly owned subsidiary corporations in other states and foreign countries. As a result, they reported no income subject to the California franchise tax.

This strategy worked for the income years 1928, the first year subject to the California franchise tax, through the income year 1934. However, in the spring of 1936 California adopted the combined report which required every corporation engaged in the conduct of a portion of a unitary business in the state to file a report including the income, not only of domestic subsidiaries, but also the income of foreign subsidiaries as well. As a result, the California corporations involved were no longer able to avoid the California franchise tax, and, instead, were required to pay several hundred thousand dollars per year in taxes which, except for the combined report, would not have been collected.

If Appellant's suggestion had been followed, the state could have applied the combined report in the case of the domestic subsidiaries but could not have applied it in the case of the foreign subsidiaries. Thus, no income would have been attributable to California resulting from the sale to foreign subsidiaries of products manufactured in the state.

Sales by domestic corporations to foreign subsidiaries are common, not only in California, but also in the other states which have adopted the combined report. Hence, if the income of foreign subsidiaries is to be exempt from the combined report requirement, the loss of much needed revenue will be substantial. Furthermore, corporations which make sales to domestic subsidiaries but do not engage in similar foreign transactions will complain bitterly of the

discrimination against them, with the result that the combined report which has proven salutary in the prevention of tax avoidance and promoting equality of treatment between single businesses and multi-corporate businesses may be jeopardized in its entirety.

2. Excessive Taxation.

If the combined report is restricted to domestic corporations, there may well be excessive taxation in many instances. This point may be illustrated by reference to *Superior Oil Company v. Franchise Tax Board*, 60 Cal.2d 406, 34 Cal.Rptr. 545 (1963). Superior was a non-integrated company engaged in the exploration and drilling for oil and extraction of oil which was sold at the wellhead. According to separate accounting computations, it realized a net income in California of some $10,000,000 and a net income in Oklahoma of some $2,000,000. but lost some $9,000,000 in other states. Thus, it realized an overall net income of $3,000,000. The California Supreme Court held that the entire business was unitary, and, accordingly the California income should be computed by apportioning the total net income of $3,000,000 by California's apportionment formula.

Now suppose that Superior had abandoned its operations in all states other than California and Oklahoma, and instead had organized a subsidiary corporation to explore and drill for oil in various Canadian provinces. The Canadian corporation's expenditures exceeded its receipts by $9,000,000. Thus, Superior's total income in the hypothetical case is $3,000,000, the same as in the actual case. Inasmuch as the operations in Canada are an integral part of Superior's business, its income from California sources would be computed by the apportionment formula, with the result that there would be attributed to California only a portion of the overall $3,000,000 net income. If, however, the income of a foreign corporation cannot be included in a combined report, as Appellant suggests, then Superior would be

taxable on an income of $10,000,000 in California and 2,000,000 in Oklahoma or an amount of income $9,000,000 in excess of the actual amount of income.

Reference should also be made to *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980). Exxon contended that although it made substantial profits overall, it lost money in the marketing states, including Wisconsin. Suppose that instead of endeavoring to find markets for its product in various states in the United States, it had organized a marketing subsidiary which operated in one or more foreign countries. Suppose further that Exxon's income from the production of oil in the United States computed according to separate accounting methods amounted to $200,000,000, and that its foreign marketing subsidiary lost $100,000,000. As a result, Exxon's overall income is $100,000,000. If the combined report is used, only a portion of Exxon's total income would be attributable and taxed by one or more of the producing states. If, however, the combined report cannot be employed, then *Exxon* would be subject to tax by the producing states on an income of $200,000,000.

Again, suppose three affiliated corporations are engaged in the conduct of a unitary business partly in the United States and partly in a foreign country. One of the corporations is a domestic company and the other two are foreign. According to separate accounting computations, the corporation doing business in the United States realizes a profit of $1,000,000. One of the foreign corporations likewise realizes a profit of $1,000,000 and the other foreign corporation loses $1,000,000. Thus, the overall net income of the three companies is $1,000,000. Some portion of this amount would be attributed to the United States if the combined report method were used. If, however, the income of the foreign corporations cannot be included in a combined report, then the corporation doing business in the United States will be subject to tax on $1,000,000 and one of the

foreign corporations will likewise be subject to tax on a similar amount.

The possibilities of excessive taxation resulting from restricting the use of the combined report are at least as probable as the possibilities of double taxation from its continued use.

F. The Use of Separate Accounting Will Not Result in the Nation Speaking with One Voice.

Appellant asserts that the use of the combined report prevents the nation from speaking with one voice. (App's. Br. 27.)

The use of separate accounting, as Appellant suggests, will not remedy this matter, but, instead, will aggravate it and, in addition, will result in tax avoidance on a wholesale scale in many cases and in excessive taxation in others.

The arm's-length standard, which supposedly is an essential element of the separate accounting procedure, is usually artificial or contrived. The reason for this is that most corporations do not have a sufficient volume of genuine arm's-length transactions with truly independent entities to form a basis for a genuine arm's-length standard for dealing with subsidiaries. For much the same reason, the experience of other companies in the same line of business may not be helpful.

Lacking a genuine arm's-length standard, corporations selling goods or services to subsidiaries must develop their own conceptions as to the proper terms of such transactions. Such terms necessarily represent little more than a guess or conjecture on the part of the corporation, and may be biased in order to reduce the burden of taxation. Furthermore, representatives of the Internal Revenue Service or of state or foreign taxing agencies, upon the audit of returns, may well, and often do, reach different conclusions. Thus, instead of enabling the nation to speak with one voice, the use of the separate accounting procedure results in the nation

speaking with a babble of voices—as many as there are taxpayers and taxing agencies concerned.

For an emphatic and detailed criticism of the arm's-length standard, *see Controller General's Report to the House Committee on Ways and Means*, September 30, 1981. For an earlier severe criticism of the arm's-length standard, *see* Altman and Keesling, *Allocation of Income in State Taxation*, Ch. V, "Principles of Allocation of Business Income" and Ch. VIII, "Apportionment of Income of Affiliated, Related, or Controlled Taxpayers" (Commerce Clearing House, Inc., 1946) (2d Ed. 1950).

Conclusion.

Appellant insists that its foreign subsidiaries function as separate, independent businesses. However, Appellant had a hand, and, in some respects, a heavy hand in virtually all phases of the subsidiaries' operations. Furthermore, its charges for services rendered its subsidiaries were not charged on the basis that a corporation organized for profit would charge a truly independent entity. Instead, many of the services were charged on the basis of cost, and others not charged at all.

Under these circumstances, it is respectfully submitted that the lower court's decision upholding the use of the combined report should be upheld.

Respectfully submitted,

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NO. 81-523

In The

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeals
of the State of California
for the First Appellate District

BRIEF OF THE STATE OF MONTANA AS AMICUS CURIAE IN SUPPORT OF APPELLEE

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TABLE OF CONTENTS

	Pages
I. Introductory Statement	1
II. Interest of Amicus Curiae	2
III. Summary of Argument	3
IV. Argument:	
A. Multinational businesses give rise to unique audit problems.	3
B. The approach of the federal government to the problem.	6
C. Criticism of the Federal Approach	8
D. The States' approach	11
1. Criticism of the States' approach	12
2. Response to criticisms of the States' approach	13
3. Comparison of the Federal and State approach	14
V. Conclusion	15

TABLE OF AUTHORITIES

CASES:

Butler Brothers v. McColgan, 315 U. S. 501 (1941)	5
Complete Auto Transit Inc. v. Brady, 430 U. S. 274 (1977)	11
Container Corp. v. Franchise Tax Bd., 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981)	2

TABLE OF AUTHORITIES—Continued

Pages

International Harvester Co. v. Evatt, 329 U. S. 416 (1947) 13

Northwestern States Portland Cement Co. v. Minnesota, 358 U. S. 450, 462 (1959) 14

Underwood Typewriter v. Chamberlain, 254 U. S. 113 (1920) 13

Wisconsin v. J. C. Penney Co., 311 U. S. 435 (1940) 11

STATUTE:

26 U. S. C. § 482 6

FEDERAL RULES & REGULATIONS:

Treas. Reg. § 1.482-1, *et seq.* 7

Treas. Reg. § 1.482-2 (e) 7

OTHER AUTHORITIES:

Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey", *The Journal of Taxation*, (May, 1980), p. 308 9

89 Harv. L. Rev. 1202 (1976) 8, 9, 10, 14, 15

United States Supreme Court Rule 36 1

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BRIEF OF THE STATE OF MONTANA AS AMICUS CURIAE IN SUPPORT OF APPELLEE

I.

INTRODUCTORY STATEMENT

Pursuant to United States Supreme Court Rule 36, the State of Montana submits this Brief as an *Amicus Curiae* in support of the Appellee. Both parties to this proceeding have consented to the filing of this Brief.[1]

[1]Originals of the "blanket" consent letters of both parties have been filed with the Clerk of the Court.

II.

INTEREST OF AMICUS CURIAE

The interest of the State of Montana as an Amicus in this matter revolves around the potentially far reaching effects of this Court's final decision as it relates to the ability of a state to tax multi-jurisdictional businesses. The State of Montana is concerned with the Appellant's position that the application of combined apportionment to a corporation and its foreign subsidiaries on a worldwide basis constitutes a violation of the due process and commerce clauses of the United States Constitution.

It is essential that this Court affirm the decision of the California Court of Appeals in *Container Corp v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981). A decision from this Court reversing the California Court of Appeals will effectively erode several years of effort in producing relative uniformity among the states in the area of state income taxation, as well as seriously subvert the ability of the State of Montana to tax rationally the multi-jurisdictional taxpayers operating in this State.

Another ramification of such a reversing decision would be the further erosion of the Montana tax base at a time when state and local governments can ill afford the revenue loss. A multi-jurisdictional business enterprise must be subject to a state taxing authority in the same capacity as a smaller, completely localized enterprise. Any method to the contrary would create the inherently unfair result of smaller enterprise shouldering the state and local tax burden of the multinational business entity.

———o———

III.

SUMMARY OF ARGUMENT

This Brief will focus on an examination of the auditing problems posed by a multi-jurisdictional corporation to both federal and state governments as well as the respective approaches taken in determining and ultimately taxing the income of such taxpayers. This *amicus* submits that the approach taken by the states in utilizing the unitary business principle not only meets basic constitutional standards but also possesses clear advantages to the separate-entity "arms-length" approach of the Federal Government in attributing multinational corporate income for tax purposes.

IV.

ARGUMENT

A. Multinational businesses give rise to unique audit problems.

> In this age of the supercompany with its sophisticated pattern of world-wide operations and financial dealing, there is perhaps no more difficult problem for the tax administrator than the examination of the tax returns of multinational corporations.[2]

Since the end of World War II, there has been an explosion in the size of the international business community.

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[2]Donald Alexander, Commissioner of Internal Revenue, "Auditing Multinational Corporations," Address to the Assembly of Inter-American Center of Tax Administration, Ottawa, June 13, 1975.

Companies which once restricted their activities to a single country are now involved in the domestic economies of a number of countries. Business opportunities now exist on a global scale and the modern business enterprise tailors its operations to exploit the advantages offered by a variety of circumstances. As a result of this growth of business, the problems of the tax administrator have become ever more complex and exasperating. Not only are global market forces at work in shaping business decisions, but also the presence of a business in numerous jurisdictions allows significant opportunities for corporate planning to take advantage of tax opportunities or shields offered by a variety of countries.

Multinational businesses almost invariably operate through a number of legally separate entities. This does not mean that they operate as separate businesses however. In almost all cases they function as a single business. Shareholders in major corporations are concerned with bottom line results, not where income is earned. Corporate managers function in a way which satisfies stockholder expectations or they look for new jobs.

The nature of multinational businesses gives rise to unique problems for the tax administrator because they are unrestrained by the economics of a single country in making business decisions and in particular in transferring goods between related entities. Transfer prices may be relevant to a local manager if his performance is judged solely by the results he obtains in his segment of the business, but they are irrelevant to the business as a whole. The only relevant figure for the business is the difference between the cost of an item and the amount realized when

it is sold to a third party. As a consequence, transfer pricing can be utilized to influence tax results. This may not be the only reason for establishing particular transfer prices, but the fact that beneficial tax results can be achieved through appropriate pricing strategies cannot be ignored.

A multinational business may give rise to economies of scale which generate large amounts of income. This can occur whenever there is a decreasing marginal cost of production. Decreased costs may make sales profitable at a price level below those justified by the exploitation of a single market. Does the additional sale give rise to the increased profit or is the profit the result of all sales?

Beyond the direct results evident from the lowering of per-unit costs, there can also exist a number of synergistic benefits which are even more elusive of measurement. Economic benefits can arise from size alone in terms of borrowing capacities, credit requirements, supplier preference, etc. Sometimes these benefits are measurable; at other times they are intangible. In any event, they cannot be specifically identified with one activity. The synergism results from the interaction of all of the elements of the business, or at times from the existence of all of the elements as a part of the whole. In such a case the income which results should be divided among each of the constituents. It cannot be assigned to any one or several of them.

An example of a real but intangible benefit unidentifiable by source was discussed in *Butler Brothers v. McColgan*, 315 U.S. 501 (1941). In that case, the Court considered the effect of volume discounts and the stipulated fact that the elimination of California purchases would

have no effect on the amount of the discount. The Court responded in the following manner:

> . . . If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. . . .

315 U. S. at 508-09.

B. The approach of the federal government to the problem.

The Internal Revenue Code operates on the basic premise that residents of the United States, individual or corporate, are taxable on all of their income. Credits are allowed to the extent foreign jurisdictions assert tax over a portion of a resident's income because it has a source in the foreign jurisdiction. In some instances, a deferral is granted for United States taxation until the income is repatriated. Allowing credits or classifying income as being "non source" are the exception rather than the rule.

As an aid in administering the system, § 482 of the Internal Revenue Code (26 U. S. C. § 482) provides the Internal Revenue Service with policing power. It provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, owned, or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, cred-

> its, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Department of Treasury has adopted implementing regulations (Treas. Reg. § 1.482-1, *et seq.*). The regulations establish three specific methods and a fourth general method for adjusting intercorporate transactions on the basis of the arm's-length standard (Treas. Reg. § 1.482-2 (e).) Under the regulations, transactions between commonly controlled entities are reviewed and compared to hypothetical comparable transactions between unrelated entities. The regulations establish a hierachy of comparisons: the comparable uncontrolled price, the resale price, cost plus, and any other method that is clearly more appropriate.

The regulations attempt to compare intercorporate transactions to those conducted by separate entities. It views each corporation as separate and independent and uninfluenced by the existence or opportunities to deal with related entities.

> . . . Since each commonly-controlled entity is viewed as separate and independent, the government will calculate its true taxable income by adjusting intercompany transactions to conform to the results of bargains which would have been negotiated between unrelated parties dealing at arm's length in similar goods or services in similar circumstances. Moreover, each entity's profit or loss on any intercompany transaction does not depend on whether the MNC [Multinational Corporation] as a whole has yet made or ever will make any real profit through ultimate resale to

third parties of the goods or services. (89 Harv. L. Rev., *infra*, 1202 at 1205.)

C. Criticism of the Federal Approach.

The separate entity approach followed by the Federal Government has been subject to substantial criticism. This criticism has come from legal scholars Geoffry John Harley, "International Division of the Income Tax Base of Multinational Enterprise", 89 Harv. L. Rev. 1202 (1976), the Treasury itself (The President's 1978 Tax Program, January 30, 1978, pp. 282-297), and the General Accounting Office ("IRS Could Better Protect U. S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981) among others.

As the following extracts demonstrate, the federal approach is theoretically inappropriate because the separate entity approach does not conform with economic reality. Commonly controlled corporations are aware that additional benefits to the business as a whole may be derived from dealing with one another; therefore, they do so.

> Whenever commonly-controlled entities directly contribute, either horizontally or vertically, to a single production-distribution process, opportunities for cost savings through economies of scale and reduced transaction costs may result. Even where no direct transfers are made, centralized managerial control over a group of affiliates may produce efficiencies in management, in raising capital, in obtaining quantity discounts, and in advertising. In addition, diversification of risk creates potential savings where there are few similarities between affiliates.
>
> Finally, political and economic power, which may be used to increase long-run profits of the whole MNC, may stem from large size alone regardless of the de-

gree of compatibility between the affiliates. As a result of all of these considerations, transfer prices may vary from arm's langth to reflect the increased profitability of intercompany transactions.

89 Harv. L. Rev., *supra,* 1202 at 1215.

Some [corporate] officials believed the fundamental concept of arm's length dealing between related corporations is unrealistic. In a world of competition among multinational firms, they ask why the parent corporation should not favor its subsidiaries over unaffiliated corporations. The subsidiaries are expected to pay dividends while the unaffiliated corporations are not.

GAO, *supra,* at p. 44.

Section 482 is based on the premise that a subsidiary is legally and economically separate from its parent corporation. In contrast, only 41% of the participants state their organizations actually operate in this manner. Although composed of numerous legally separate entities, 49% of the participants reveal that their companies make most intercompany pricing decisions as though the organization *is one economic unit.* This basic difference in philosophy between the IRS and multinational corporations is central to the Section 482 controversy. Without this fundamental difference, many tax problems involving intercompany transfer pricing would disappear.

Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey", *The Journal of Taxation,* (May, 1980), p. 308.

Such an approach may give rise to artificially created records and may eliminate the use of one of management's tools for evaluating employees or rewarding performance.

. . . The government's insistence on the separate entity theory for tax purposes may result in the adop-

> tion by MNC's of arm's length pricing rather than an administered transfer pricing system more appropriate for internal control and motivational purposes. Such a system, which is designed to reflect the fact that an affiliate may have contributed to long-run MNC profits despite its failure to produce short-run profits measured in terms of arm's length prices, is crucial to the promotion of full cooperation by all affiliates in achieving the MNC's world-wide goals, even when it is not in their individual interest as profit maximizers.
>
> 89 Harv. L. Rev., *supra,* 1202 at 1217.

In addition, the separate entity approach may give rise to significant administrative costs and burdens.

> Some [corporate] officials drew attention to the expense and labor involved in international examinations. The officials objected to what they considered an unnecessary load of paperwork. For example, the tax manager of one company declined to guess the cost of satisfying IRS examiners that international transactions do not violate section 482 regulations, although he believed the costs to be considerable. He said that he did not object because he considers the defense against IRS allocations a necessary function of his tax department. He did state, however, that the examiners raise many questions that take time and trouble to answer without being closely related to the examination.
>
> GAO, *supra,* at 44.

Finally, the separate entity approach as represented by the arm's-length standard does not work,

> . . . The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. . . . Although many multinational com-

> panies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.
>
> Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.
>
> President's Tax Program, *supra,* pp. 286-287.

and constitutes an administrative and taxpayer nightmare,

> In its review of current IRS examination data on 519 U. S. multinationals, each having assets over $250 million and having engaged in transactions with its foreign subsidiaries, GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income were based on a true arm's length price. The remaining adjustments were based on estimated prices constructed by IRS using complex guidelines prescribed by the department of the Treasury-guidelines which have caused administrative burden and uncertainty both for IRS and taxpayers.
>
> GAO, *supra.*

D. The States' approach.

The States, in applying their corporate income taxes, are limited to source income by due process considerations. *Wisconsin v. J. C. Penney Co.,* 311 U. S. 435 (1940); *Complete Auto Transit Inc. v. Brady,* 430 U. S. 274 (1977).

In order to make source determination, the States have adopted the unitary business principle. Under this approach, the States first determine the nature of the business undertaken in their state and then include all the income, wherever and by whomever earned, of that business in an apportionment base. This base is then assigned to the various jurisdictions where the business is taxable upon the basis of a mathematical formula reflecting business activities. The formula typically includes property, payroll and sales.

The unitary business principle is unconcerned with where income is assigned on the corporate books or records. It assumes that all elements of a business contribute to the earning of income. If the business does not earn income on an overall basis, then there is no income to assign anywhere.

1. Criticism of the States' approach.

The unitary approach is criticized on the grounds that the elements of the apportionment formula (property, payroll and sales) are not equally productive of income in every jurisdiction.

Second, it is asserted the perimeters of a unitary business are difficult to define and frequently shift solely on the basis of the amount of taxes which accrue to a state based upon a particular configuration.

Third, it is alleged that compliance costs under the unitary method are excessively burdensome because taxpayers do not maintain adequate records to calculate property, payroll and sales on a uniform basis.

Finally, it is claimed that the use of the unitary method may give rise to multiple taxation in the inter-

national context where foreign countries utilize the arm's-length method.

2. Response to criticisms of the States' approach.

Criticism of the formula elements misses the point of the unitary business principle. The unitary method is utilized because the income is part of an inseparable whole. As the Court stated in *Underwood Typewriter v. Chamberlain,* 254 U.S. 113 (1920):

> . . . The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the state. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach only the profits earned within the state. . . .
>
> 254 U.S. at 120-21.

Furthermore, the elements of the formula frequently offset each other. When property costs are high, payroll costs may be low. Sales may offset both. In order to overcome the presumption attached to the formula, the taxpayer must demonstrate how all the elements together have unfairly apportioned income. It should also be kept in mind that mathematical precision is unnecessary. A rough approximation is sufficient. *International Harvester Co. v. Evatt,* 329 U.S. 416 (1947).

In the instant case, the perimeters of the unitary business are defined on a line-of-business approach. This

meets the requirements of the Multistate Tax Commission Regulation Reg. IV.(1).(b), and is in conformity with the suggestions of commentators. (*See,* 89 Harv. L. Rev., *supra,* at 1235.) This Court should not speculate on the effects of the use of the unitary method in cases not before it.

The compliance cost arguments are raised with respect to either the arm's-length method or the single entity approach. The unitary method, by ignoring individual transactions, should be less burdensome in any event. The existence of additional costs in the instant case are virtually precluded by the Securities and Exchange Commission filing requirements with respect to its Form 10-K.

The use of an apportionment approach precludes multiple taxation. "Logically it is impossible, when the tax is fairly apportioned, to have the same income taxed twice." *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 462 (1959).

3. Comparison of the Federal and State approach.

The unitary entity theory has certain clear advantages over the separate entity approach now embodied in the section 482 regulations. Principal among these is its theoretical superiority as a means for ascertaining true income of various MNC components. Treatment of the MNC as a unitary entity reflects the fact that strong interdependence from common control may exist which renders unrealistic any analogy to a collection of unrelated, competitive companies. Furthermore, the unitary entity theory does not create taxable income on the basis of intercompany transfers, since such transfers do not make the MNC as a whole better off until income is realized

> from ultimate sales to unrelated parties. Finally, a unitary formula provides management with the flexibility necessary to make efficient use of transfer pricing for internal and external non-income tax purposes, thus avoiding the frustration of legitimate business behavior which may accompany application of the separate entity theory.
>
> 89 Harv. L. Rev., *supra,* 1202 at 1228.

The GAO in its report, *supra,* recommended that the Department of Treasury:

> Begin a study to identify and evaluate the feasibility of ways to allocate income under section 482, *including formula apportionment,* which would lessen the present uncertainty and administrative burden created by the existing regulations. (Emphasis added.)
>
> GAO, *supra,* at pp. viii-ix.

———o———

V.

CONCLUSION

It is respectfully requested that this Court sustain the unitary business principle and affirm its application by California in this case.

Respectfully submitted,

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IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION AND PARTICIPATING STATES

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ON APPEAL FROM THE COURT OF APPEAL
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FOR THE FIRST APPELLATE DISTRICT

BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION AND PARTICIPATING STATES[1]

1. This brief is submitted by the Multistate Tax Commission and participating states in support of the Appellee. The parties have consented to the filing of this brief and originals of the consent letters have been filed with the Clerk of the Court.

TABLE OF CONTENTS

Page

Statement of Interest 1

The Argument 9

I. General Introductory and Constitutional Considerations 9

II. The Worldwide Combination Method Is Not Facially Invalid Under the Due Process Clause 15

III. Container's Due Process Arguments Lack Merit Because Container Has Not Borne Its Burden of Proving by Clear and Cogent Evidence that California's Application of Worldwide Combined Reporting Taxed Any of Container's Extraterritorial Net Income 16

IV. Contrary To Its Argument, Container Has Not Shown That California's Use of the Combination Method Results in the Taxation of Income That Was Also Taxed By Foreign Countries 20

V. Substantial Evidence in the Record Supports the Lower Court's Holding That Container and Its Subsidiaries Conducted a Unitary Business Sufficient to Meet the Rational Relationship Test of the Due Process Clause 22

Conclusion 30

TABLES OF AUTHORITY

Table of Cases

Page

Adams Express Co. v. Ohio State Auditor, 165 U.S. 194 (1896), *aff'd on rehearing*, 166 U.S. 185 (1897) 10,12

American Cement Corp. v. Graves, 299 U.S. 517 (1936) 17

ASARCO Inc. v. Idaho State Tax Comm'n, _____ U.S. _____, 102 S. Ct. 3013 (1982) 10-11,22,23

Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924) 5,11,12,15,21,*passim*

Butler Bros. v. McColgan, 315 U.S. 501 (1942) 6,11,12,14,16

Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 417 N.E. 2d 1343 (1981), *aff'g* 77 Ill. App. 3d 90, 395 N.E. 2d 1167 (1979), *appeal filed sub nom Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (*argued* Apr. 19, 1982, *reh'g granted* May 3, 1982) 2,9,14,15,*passim*

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Coca Cola Co. v. Dep't of Revenue, 271 Or. 517, 533 P.2d 788 (1975), *aff'g* 5 Or. T.R. 405 (1974) 14

Crawford Mfg. v. State Commissioner of Revenue, 180 Kan. 352, 304 P.2d 504 (1956) 14

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Page

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Ford Motor Co. v. Beauchamp, 308 U.S. 331 (1939) ... 12

Forthingham v. Mellon, 262 U.S. 447 (1923) 10

Fry Roofing v. Wood, 344 U.S. 157 (1952) 29

F.W. Woolworth, Inc. v. Taxation & Revenue Dep't of New Mexico, _____ U.S. _____, 102 S. Ct. 3128 (1982) 10,11,22,23

Grayson v. Harris, 267 U.S. 352 (1925) 29

GTE Automatic Elec., Inc. v. Allphin, 68 Ill. 2d 326, 369 N.E.2d 841 (1977) 1

Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931) 12,20,23

International Harvester Co. v. Dep't of Treasury, 322 U.S. 340 (1944) 13

International Harvester v. Evatt, 329 U.S. 416 (1947) . 12

In re Morton Salt Co., 150 Kan. 650, 95 P.2d 335 (1939) 14

Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 13,22

John Deere Plow Co. v. Franchise Tax Bd., 38 Cal. 2d 214, 238 P.2d 569 (1951) 14

Page

Joslin Dry Goods Co. v. Dolan, _____ Colo. _____, 615 P.2d 16 (1980) 14

Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976) .. 13

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) 5,6,11,12,13,*passim*

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Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) 10,12,13,17

Multistate Tax Comm'n v. United States Steel Corp., 659 F.2d 931 (9th Cir. 1981) 24

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Multistate Tax Comm'n v. United States Steel Corp., No. 82-3181 (9th Cir. Briefs submitted) 24

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Norfolk & Western Ry. v. Missouri State Tax Comm'n, 390 U.S. 317 (1968) 12,23

Norfolk & Western Ry. v. North Carolina, 297 U.S. 682 (1936) 17

Northwestern Airlines, Inc. v. Minnesota, 322 U.S. 292 (1944) 13

Northwest States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) 13

Norton Co. v. Dep't of Revenue, 340 U.S. 534 (1951) .. 13

Page

Peck & Co. v. Lowe, 247 U.S. 165 (1918) 11

Portland Ry., Light & Power Co. v. Railroad Comm'n, 229 U.S. 397 (1913) 29

Standard Pressed Steel Co. v. Dep't of Revenue, 419 U.S. 560 (1975) 13

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) 3,11,12,17,22

United States v. New Mexico, _____ U.S. _____, 102 S. Ct. 1373 (1982) 13

United States Steel Corp. v. Multistate Comm'n, 434 U.S. 452 (1978), *aff'g* 417 F. Supp. 795 (S.D.N.Y. 1976) 1,11,24

Webb Resources Inc. v. McCoy, 194 Kan. 758, 401 P.2d 870 (1965) 14

Western Auto Supply Co. v. Commissioner of Taxation, 245 Minn. 346, 71 N.W.2d 797 (1955) 14

Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) .. 10,23

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Statutes

Uniform Division of Income for Tax Purposes Act (UDITPA)

UDITPA § 1(a) 1

UDITPA § 1(e) 1

UDITPA §§ 1-22, 7A U.L.A. 91092 (1978) 1

Page

UDITPA §§ 4-8 1

UDITPA § 18, Cal. Rev. & Tax Code § 25137 20

Rules and Regulations

IRS § 482 4

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Page

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7 Multistate Tax Commissions Ann. Rep. 64 (1973-74) 24

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STATEMENT OF INTEREST

The Multistate Tax Commission (hereinafter referred to as the Commission) is the official administrative agency of the Multistate Tax Compact (hereinafter referred to as the Compact) entered into currently by 19 states and the District of Columbia as full members and by 11 states as associate members.[2]

In the area of state income taxation of a multijurisdictional business, Article IV of the Compact sets forth the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).[3] UDITPA apportions "business income" of a unitary trade or business, irrespective of the corporate form in which it is conducted, in accordance with the well-recognized three-factor apportionment formula of tangible property, payroll and sales. "Nonbusiness income" is specifically allocated by UDITPA §§ 4-8.[4] UDITPA should be interpreted to carry out its purpose which is to provide for uniformity and full accountability (without duplication) in the division of income for state income tax purposes by workable and rational division of income rules.[5]

---

2. The constitutionality of the Compact was upheld by the United States Supreme Court in *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978), *aff'g* 417 F. Supp. 795 (S.D.N.Y. 1976). The Court there noted that the Compact "symbolized the recognition that, as applied to multistate businesses, traditional state tax administration was inefficient and costly to both state and taxpayer." *Id.* at 456.

3. Uniform Division of Income for Tax Purposes Act (UDITPA §§ 1-22, *reprinted in* 7A U.L.A. 91 (1978). UDITPA was promulgated in 1957 by the National Conference of Commissioners on Uniform State Laws.

4. UDITPA § 1(a) defines "business income" as:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Section 1(e) defines "nonbusiness income," which is subject to specific allocation, as "all income other than business."

5. *See* prefatory note to UDITPA, 7A U.L.A. 91-92 (1978); *GTE Automatic Elec., Inc. v. Allphin*, 68 Ill. 2d 326, 369 N.E.2d 841 (1977); Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 749 (1957).

In the instant matter, and in the pending appeal of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (*argued* Apr. 19, 1982, *reh'g granted* May 3, 1982) (hereinafter referred to as *CBI*), the Commission and participating states are concerned with the unsubstantiated argument that an established international tax policy[6] exists for the ascertainment of the United States income of United States parent corporations and their controlled foreign subsidiaries and affiliates. We are further concerned with the argument that this alleged policy precludes the constitutional employment of worldwide combined reporting (the unitary method applied to a group of corporations or other legal entities which conduct an integrated unitary business in part through "foreign affiliates," hereinafter referred to as the combination method, combined reporting, or combination). This Court should not permit the policies of the United States Treasury Department (hereinafter referred to as Treasury) to indiscriminately spill over and dictate state tax policies. We believe that this matter should be resolved by Congress, not by Treasury or this Court. Acceptance of Container's argument would open the floodgates to state income tax avoidance by large multinational corporations by permitting them to use their own internal accounting devices and the corporate form in which they conduct their business to shift their profits anywhere in the world.[7]

---

6. While there may be international agreements between the United States and certain other nations pertaining to taxation of the domestic operations of foreign parent corporations, including their foreign affiliated and subsidiary corporations, no such agreements exist as to how nations will tax their own domestic corporations, including their foreign subsidiary and affiliated corporations. Absolutely nothing in the record in this cause substantiates Container's argument that any international standards, agreements or norms exist or that the unitary method here involved conflicts with these alleged standards, agreements or norms.

7. The need for "combined reporting," on the international level, can be illustrated by an actual example of a multinational corporation conducting unitary operations in Canada and Idaho through two subsidiary corporations. The Canadian subsidiary processes pulp used for the manufacture of paper by the American subsidiary. The pulp is transported from the Canadian subsidiary to the American subsidiary by a pipeline crossing international boundaries. Under these

We are further concerned with Container's use of abstract theoretical due process arguments to invalidate reasonable apportionment results and with its position that its relationship with its foreign subsidiaries was insufficient to permit combination without violating due process.

SUMMARY OF ARGUMENT

Container and its *amici* contend that the judgment below is unconstitutional because: (1) it conflicts with international tax policy, contrary to the limitations of the commerce clause; (2) worldwide combination "misapportions income to the United States members of the group, resulting in extraterritorial taxation in violation of the due process clause" (Appellants Br. at 9); (3) the "income missapportioned to the United States members of the group is fully taxed in the foreign country where it was earned," (*id.*) and therefore "the income is subject to double taxation, in violation of the commerce clause" (*id.*); and (4) Container did not conduct a unitary business with its subsidiaries for the years in question.

The question of whether an established international tax policy exists, and whether this alleged policy conflicts with worldwide combined reporting, is thoroughly analyzed in the brief *amicus curiae* of the Multistate Tax Commission and participating states in the *CBI* case at III pp. 17-24. No international policy for the attribution of net income exists. If this policy did exist, it would not prohibit or restrict the states' authority to employ combined reporting, or any other method, to ascertain the apportionable net income

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Footnote 7 (con't)

circumstances, it is impossible to separate the profits of the Canadian subsidiary from that of the American subsidiary because the profits of the two corporations from the manufacture of pulp and paper products were earned by a series of transactions beginning in Canada and ending in sales in the United States. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). Thus, logic dictates that "combination" be utilized to determine the profits of either of these two subsidiaries.

(hereinafter referred to as apportionable income[8]) of Container, or any other U. S. domestic corporation. *Id.* at 16 n.32. Container and its *amici* are simply asking the Court to require the states to use the intercorporate separate accounting of a multinational corporation (hereinafter referred to as a MNC) which conducts a part of its unitary business in foreign countries through subsidiary corporations, to determine apportionable net income.[9] In this case, Container relies solely on the separate accounting of its book net profits and that of its subsidiaries to support its "facial," "as applied," distortion, and double taxation arguments. Exhibit A at 1-6.

In regard to these arguments, Container does not separate its *facial attack* from its *as applied attack* on worldwide combination; Container does not separate the "facts" it relies on to support its *distortion argument* from the "facts" it relies on to support its *"double taxation" argument.* However, these distinct issues must be separately considered since these issues are not addressed to either common legal or factual questions.

In regard to Container's "double taxation" argument, the record does not show that combination has attributed any net income to the United States which has *in fact* been taxed by the foreign countries in which Container's subsidiaries conducted business for the years in question. Neither does the record establish that California has attributed to U. S.

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8. The phrase "apportionable income" refers to a multijurisdictional taxpayer's tax base which is divided by an apportionment formula among those states in which the taxpayer does business. *See infra* note 15.

9. To support its double taxation and distortion arguments, Container erroneously uses the terms "separate accounting" and "arm's-length" synonymously. Further, Container improperly relies on its separate accounting of net profits, not net taxable income. Because IRS § 482 audits are unusual and special procedures, the IRS audit of Container for the years in question was not an "arm's-length" adjustment audit. This is demonstrated by the fact that the tax comparisons between combination results and the results Container asserts are here controlling are based on its own "separate accounting" and not on any so called "arm's-length" analysis by any country.

sources any net taxable income which is not attributable to U. S. sources for federal income tax purposes if any reasonable allowance is made for the admitted understatement of U. S. source net income by Container's "separate accounting." (*See infra* notes 10-11.) Thus, Container's double taxation argument is not supported by any proof of either extraterritorial or double taxation by California.

In regard to Container's "distortion" argument, it has not attempted to prove that the combination method, as applied by California, has attributed any net income to California which is disproportionate to its extensive California operations. A difference between an apportionment result and separate accounting does not invalidate an apportionment result.

Notwithstanding the foregoing, Container and its *amici facially* attack worldwide combination on the premise that worldwide combination attributes too much income to U. S. sources because of: (1) the distortion in the payroll factor; (2) the higher expected rate of return of U. S. based MNCs on their foreign operations as compared to their expected rate of return on their domestic operations; and (3) double taxation of income which has been earned in and taxed by foreign countries.

Worldwide combination *per se* has nothing to do with these issues. Combination simply requires a unitary business, which is conducted by a group of corporations, to be treated as a single business for income attribution purposes in the same manner as though the business was conducted as branches or divisions of a single corporation. The arguments of Container and its *amici* to facially attack worldwide combination are equally relevant if the foreign operations of a United States MNC are conducted by overseas divisions. Since the states clearly have the authority to combine the income of overseas branches to determine the boundaries of a unitary business for apportionment purposes (*see Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924) which was cited with approval in *Mobil* and other decisions of this Court), a facial attack against combined reporting cannot be sustained (*see also Mobil*, 425 U.S. at 440-41).

Neither has Container advanced any valid reasons to support its argument that worldwide combination *as applied* to its business affairs results in either distortion or international double taxation. In support of its *as applied* argument, in addition to the reasons advanced by Container to support its facial attack, Container contends: (1) that it has proved that California's use of worldwide combined reporting actually results in the misapportionment of its net income to California and subjects the combined net income of Container and its subsidiaries to double taxation; and (2) that it did not conduct a unitary business with its foreign affiliates. Container has not proved its case because it bases its *as applied* argument (as well as its *facial* argument) on the following erroneous assumptions and erroneous factual conclusions:

First, that its "separate accounting" for its net profits and that of its subsidiaries appropriately determines its net taxable income from U.S. sources, and the "foreign source" net taxable income of its subsidiaries. However, book net profit is not taxable income.[10] The record conspicuously fails to indicate actual net taxable income of Container's subsidiaries as reported to foreign countries for foreign income tax purposes. In addition, Container admits that this "separate accounting" is inaccurate.[11] In any event, separate accounting does not invalidate an apportionment result. *See Exxon; Mobil; Butler Bros.*

Second, Container's argument is based on the erroneous assumption that one-third of net taxable income under UDITPA is attributable to payroll costs (Appellant's Br. at

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10. The net book profits of Container and affiliated corporations, which is set forth on Exhibit A, do not constitute the *net taxable income* for U. S. federal tax purposes or for the tax purposes of foreign countries in which its affiliated corporations conduct business. As to Container, this is demonstrated by comparing federal taxable income in Exhibit A at 7 with the net profit figures of Container set forth in Exhibit A at 2, 4, 6.

11. Container was not compensated for some services which it provided its subsidiaries (JA ¶ 144 at 74); it sold used equipment to them at book rather than fair market value (*id.*, ¶ 144 at 76); it brokered equipment to them at a fee less than would be charged a third party (*id.* ¶ 148 at 77); it received no fees for loans it guaranteed for its subsidiaries and it charged minimal interest on loans made to them.

14) and that the unitary apportionment method is based on the premise that each dollar of payroll expense produces an equal amount of net income (*id.* at 11). On the contrary, the UDITPA three factor formula is based on the premise that the location of a taxpayer's tangible property, payroll and sales taken together roughly approximates the geographical locations of the net income of a unitary business. Further, no particular portion of net income is attributable to any one factor or to any geographical location to which that factor assigns net income.

Third, Container's argument is based on the unproven assumption that profits in foreign countries are higher per dollar of investment than in the United States because MNCs anticipate this result. Appellant's Br. at 14. Three of Container's affiliates incurred net losses based on their separate accounting in 1963, four operated at a net loss in 1964 and one in 1965. Exhibit A at 1, 3, 5. These facts destroy Container's argument that its foreign subsidiaries operated at higher profit rates.

Fourth, Container's reliance upon the table at page 17 of its brief, which is constructed from separate accounting of net profits as reported on its federal IRS 2952 information schedules, further demonstrates the erroneous foundation of Container's argument. By definition, the information on these schedules is not accurate and contains estimates and approximations that are determined by separate accounting — they do not represent the net taxable income which was subject to tax by any foreign country or by the United States. For example, Container's IRS form 2952 shows that the Italian subsidiaries had an average income of $34,000 for the tax years at issue. Appellant's Br. at 17. But Container's 2952 form also shows that the Italian subsidiaries had an average tax liability of $121,044 for these same years (JA ¶ 159 at 84), which represents 356% of their average pre-tax income. The inherent inaccuracy of Container's 2952 form is further demonstrated in Exhibit A where Container's net profits are listed as $25,361,936 for 1963; $28,975,400 for 1964; and $30,026,749 for 1965 (Exhibit A at 2, 4, 6) even though Container's federal taxable income substantially exceeded these amounts (*id.* at 7). Thus,

Container's distortion and double taxation arguments are not based on amounts actually attributable to either the IRS or to the foreign subsidiaries for income tax purposes.

Fifth, Container's reliance upon the differences between payrolls and rates of return are not substantiated by the claimed misapportionment of income as set forth in the table at page 17 of its brief. Container's allegation that the California wage rate is two hundred fifty percent that of the wage rate paid to workers in Cali, Colombia, if appropriate at all, hardly demonstrates the invalidity of the mere 9.5% difference[12] between net income attributable to the United States by worldwide combined reporting and by Container's net profits assigned to different countries by Container's separate accounting.[13]

In sum, Container simply relies on its internal separate accounting to attack the combination method on its face and as applied by California. Since Container has not attempted to prove California *actually* taxed extraterritorial income, Container has failed to carry its burden of proving that California's use of the combination method took its property without due process of law. Neither has Container proved any *actual* double taxation.

Neither is there merit in Container's argument that the court below denied it due process of law in concluding that it conducted a unitary business with its foreign subsidiaries. The thirty-seven facts taken from the stipulated facts, *infra* pp. 27-29, illustrate that the subsidiaries were not conducted as discrete businesses so unrelated to Container's own business that combination denied Container due process of law. Any reasonable inference from these and other facts support the proposition that Container formed and utilized

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12. This is the difference between the total worldwide net profits attributable to the United States by Container's separate accounting as compared to worldwide combined reporting. It is obtained from the figures set forth on page 17 of Appellant's Brief.

13. The tax liabilities shown on the 2952s as having been paid to foreign countries are not accurate (JA ¶¶ 159-61 at 83-85) and otherwise do not prove double taxation of net income.

its foreign subsidiaries to further its container business throughout the world and that it used its total resources as needed in furtherance of this purpose. From the record in this case, we discern little difference between the type of centralized management and control that Container exercised over its foreign operations than it exercised over its domestic operations.

If the unitary business principle is going to have any continued vitality in the field of state net income taxes, consideration must be given to the modern methods of how integrated businesses are conducted. Top management of large multinational corporations realistically cannot control any of their far flung operations except through advanced planning, approval of major decisions, financing, review of operations through the submission of reports, the placing of persons in key positions, and the promolgation of basic corporate policies, etc. throughout the total enterprise. If the states cannot rely on reasonable presumptions that can be drawn from the general character and mode of operations of particular MNCs to determine whether they are conducting a unitary business sufficient to satisfy the "minimal connection" and " rational relationship" due process standard, the states will be completely unable to uniformly and fairly administer the unitary business principle.

THE ARGUMENT

I. General Introductory and Constitutional Considerations

The broad issue before this Court is what constitutes the extent and nature of the fundamental constitutional restrictions on the sovereign taxing powers of the states within our federal system.[14] The narrow issue here is to what extent California can use the combination method[15] to determine Container's net income attributable to its business activities in California.

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14. *See generally* P. Hartman, *Federal Limitations on State and Local Taxation* (1981).

15. The term "unitary business principle" is used in two separate and distinct contexts. The first context, the *combination method* at issue here and in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (*reh'g granted* May 3, 1982), is used to determine which of two or more

Inasmuch as Container is not a champion of any constitutional rights except its own, *Forthingham v. Mellon*, 262 U.S. 447, 487-88 (1923), these issues must be resolved in regard to the specific facts and circumstances pertaining to Container, not by abstract hypothetical considerations. In resolving these issues, this Court's function is not to determine whether the combination method or any other method employed by the states is the most fair and equitable method. The study and potential promulgation of uniform state tax laws involves complex questions which require political, not judicial, resolution. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278-80 (1978). This Court has repeatedly held that a state is free to design any tax system it wishes so long as that tax system does not impinge on a taxpayer's fundamental constitutional rights. *Moorman; Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

An understanding of the basic principles upon which the "unitary business principle"[16] is constructed will aid resolution of the complex issues in this case. Beginning with the early property tax case of *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1896), *aff'd on rehearing*, 166 U.S. 185 (1897) through *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980)[17] this Court has uniformly

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Footnote 15 (con't)

corporate entities should be regarded as being engaged in one "unitary business" and should therefore be "combined" or treated as a single corporation for state tax reporting purposes. The second context, the *unitary apportionment method* at issue in *ASARCO Inc. v. Idaho State Tax Comm'n*, No. 80-2015 and *F.W. Woolworth, Inc. v. Taxation & Revenue Dep't of New Mexico*, No. 80-1745 (Petition for Rehearing pending), is used to determine what income is attributed to the unitary business and is thus subject to apportionment among the states in which the business is conducted. This brief uses the term "apportionable income" to describe this income. *See supra* text accompanying note 8. *See generally* Dexter, *Post Oral Argument Comments on ASARCO and Woolworth*, 15 Tax Notes No. 11 at 867 (June 14, 1982).

16. *See supra* note 15.

17. Because a Petition for Rehearing is pending and this Court's mandates have not issued in either *ASARCO, Inc. v. Idaho State Tax Comm'n*, ____

sustained reasonably apportioned state imposed property, franchise, or net income taxes. This Court has consistently held that the states are free to use the "unitary business" technique even if some components of the unitary business are located outside the taxing jurisdiction, including foreign countries. *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978), *aff'g* 417 F. Supp. 795 (S.D.N.Y. 1976); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

This Court has recognized that "net income taxes," unlike gross receipt taxes, are not imposed on any transactions from which net income may be derived. *Peck & Co. v. Lowe*, 247 U.S. 165 (1918). Thus, "[n]either the privilege nor the burden is affected by the character of the source from which the income is derived." *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313 (1936). For purposes of state corporate taxes "net taxable income" is a highly abstract concept,[18] representing only a relatively small part of the taxpayer's business receipts. Taxation of net income is *not* the taxation of any specific item, activity, or property of the business.[19] "Separate accounting" results do not impeach the validity of assignment of net taxable income by the formulary apportionment method.[20] This Court has upheld unitary apportionment, even though applied to income from foreign activities of a foreign corporation which earned no taxable income in the United States for federal income tax purposes.

Footnote 17 (con't)

U.S. ___, 102 S. Ct. 3013 (1982) and *F.W. Woolworth, Inc. v. Taxation & Revenue Dep't*, ___ U.S. ___, 102 S. Ct. 3128 (1982), we believe it inappropriate to refer to these cases as established authority.

18. Dexter, *The Attribution of the Net Income of Multistate-Multinational Corporations for State Income Taxes on or Measured by Net Income*, 1 Multistate Tax Comm'n Rev. No. 1 at 5 (Nov. 1981).

19. Compare *Crew Levick Co. v. Pennsylvania*, 245 U.S. 292 (1917) with *Peck & Co. v. Lowe*, 247 U.S. 165 (1918).

20. *See Exxon; Mobil; Butler Bros.*

Bass, Ratcliff & Gretton. It has also held that all aspects of a business presumptively contribute to the operations of the business as a whole. *Adams Express*, 165 U.S. at 227. Apportionment formulas are based on the premise that geographical sourcing is impossible where the instate and out-of-state activities are interdependent[21] and that it is necessary and constitutionally permissible to assign net income under these circumstances to where the instate and outstate business is conducted, as reflected by the rough approximation of an apportionment formula. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278-80 (1978); *International Harvester v. Evatt*, 329 U.S. 416 (1947).

This Court has invalidated an apportionment formula only when the taxpayer has proved by clear and cogent evidence that the formula taxed extraterritorial income or values. *Moorman Mfg. Co.; Butler Bros.; Norfolk & Western Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931). It has thus upheld a single property factor apportionment formula (*Bass, Ratcliff & Gretton; Underwood Typewriter Co.*) and a single sales factor apportionment formula (*Moorman Mfg. Co.; Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939)).

In applying the foregoing constitutional standards, the Court has held that the taxpayer's corporate business form is not controlling in determining the apportionable net income. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 440-41 (1980). Rather, it has held that the unitary business principle is controlling for this purpose.[22] *Id.* at 439. However, the apportionment of the income or property of a unitary business may be invalidated if the apportionment results in extraterritorial taxation. *Norfolk & Western Ry.; Hans Rees' Sons, Inc.*. Thus, the fundamental due process question is whether a state, regardless of the method used, taxes extraterritorial values or income.

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21. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920).

22. The linchpin of apportionability should be whether the apportionment result is constitutionally reasonable, not the unitary business method *per se*. *See infra* pp. 23-25.

While this Court has held that the purpose of the commerce clause is to prevent any undue multiple burdens on interstate commerce, it has also held that any prohibited risk of multiple taxation is satisfied by reasonable apportionment rules. *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 448-49 (1959). It has also refused to engage in hypothetical reasoning or speculation in resolving any alleged multiple taxation question. *Moorman*, 437 U.S. at 276; *First Fed. Sav. & Loan v. Tax Comm'n Ass'n*, 437 U.S. 255, 262 n.9 (1978); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975); *Northwestern States Portland Cement Co.; Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292-95 (1944); *International Harvester Co. v. Dep't of Treasury*, 322 U.S. 340, 348 (1944).

This Court has properly noted that "[c]oncurrent federal and state taxation of income, of course, is a well-established norm" (*Mobil*, 445 U.S. at 448) and that "[a]bsent some explicit directive from Congress, we [the Court] cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." (*id.*; bracketed material added). It has thus emphasized that "absent congressional action . . . the States' power to tax can be deprived only under 'the clearest constitutional mandate' *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976)." *United States v. New Mexico*, __ U.S. __, 102 S. Ct. 1373, 1384 (1982).

In sum, this Court has concluded that if a state tax is fairly apportioned and non-discriminatory, if it is applied to an activity with substantial nexus in the state, and if it is designed to reasonably compensate the state for services provided, then a state tax does not contravene either the due process clause (*Moorman*, 437 U.S. at 272) or the commerce clause (*Japan Line*, 441 U.S. at 444-45) limitations on state taxing power. Further, the taxpayer carries the burden of proving that a state tax is unconstitutional by showing a lack of connection between its instate activities and that which the state has sought to tax. *Mobil*, 445 U.S. at 442; *Norton Co. v. Dep't of Revenue*, 340 U.S. 534, 537 (1951).

In the application of the foregoing general constitutional principles, the state courts were faced with a question of what criteria to use to determine when a taxpayer conducted a unitary business and what should be the result when a unitary business is conducted by the taxpayer in conjunction with commonly owned and controlled affiliated corporations.

The cases hold that a unitary business is being conducted if the business is owned and controlled by the same interests and the component parts of the business are so interrelated and interdependent that they form one business unit rather than separate discrete business enterprises.[23] In determining whether a business is unitary, no case holds and no study concludes[24] that the corporate form in which the business is conducted is controlling.[25]

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23. The basic tests utilized by the state courts to determine what constitutes a unitary business are set forth in Dexter, *The Unitary Concept in State Income Taxation of Multistate Multinational Businesses*, 10 Urb. Law. 181 (1978).

See also Exxon; Mobil; Butler Bros. v. McColgan; Chase Brass & Copper Co. v. Franchise Tax Bd., 10 Cal. App. 3d 496, 95 Cal. Rptr. 805 (1970); *John Deere Plow Co. v. Franchise Tax Bd.*, 38 Cal. 2d 214, 238 P.2d 569 (1951); *Zale-Salem, Inc. v. State Tax Comm'n*, 237 Or. 261, 391 P.2d 601 (1964); *Webb Resources Inc. v. McCoy*, 194 Kan. 758, 401 P.2d 870 (1965); *Crawford Mfg. v. State Commissioner of Revenue*, 180 Kan. 352, 304 P.2d 504 (1956); *Western Auto Supply Co. v. Commissioner of Taxation*, 245 Minn. 346, 71 N.W.2d 797 (1955).

24. *See* House Comm. on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. Vol. 4 at 1154-55 (Willis Report).

25. *See Mobil; Edison Cal. Stores Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947); *Joslin Dry Goods Co. v. Dolan*, __ Colo. __, 615 P.2d 16 (1980); *In re Morton Salt Co.*, 150 Kan. 650, 95 P.2d 335 (1939); *Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 417 N.E. 2d 1343 (1981), *aff'g* 77 Ill. App. 3d 90, 395 N.E. 2d 1167 (1979), *appeal filed sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (*argued* Apr. 19, 1982; *reh'g granted* May 3, 1982); *Montana Dep't of Revenue v. American Smelting & Ref. Co.*, 173 Mont. 316, 567 P.2d 901 (1977), *appeal dismissed*, 434 U.S. 1042 (1978); *Coca Cola Co. v. Dep't of Revenue*, 271 Or. 517, 533 P.2d 788 (1975), *aff'g* 5 Or. T.R. 405 (1974).

II. The Worldwide Combination Method Is Not Facially Invalid Under the Due Process Clause

The worldwide combination method is not facially unconstitutional[26] because of the following: (1) Container's distortion and double taxation arguments are equally relevant regardless if Container conducts business through separate foreign subsidiaries or through foreign divisions of a single corporation; (2) *Bass, Ratcliff & Gretton* holds that a state may apply its apportionment formula to a taxpayer's tax base that includes income from foreign divisions of the taxpayer's single business; and (3) *Mobil* holds that corporate form has no effect on resolving the issue of whether a state has denied due process to a taxpayer by taxing the taxpayer's extraterritorial income. Container's distortion and double taxation arguments, if they have any relevance at all, should only be addressed to the *result* when the method is *applied* to Container.[27]

The purpose of the combination method is to treat two or more separate corporations as a single business unit for net income apportionment purposes when they would be treated as a unit if their combined businesses were conducted as divisions of a single corporation.[28] A ruling in favor of Container and its *amici* that worldwide combination is facially invalid would dictate a ruling against Caterpillar Tractor Co. in *CBI*, where both the state and the taxpayer (Caterpillar) agree that application of worldwide combined reporting is necessary to prevent unreasonable and unconstitutional attribution of Caterpillar's income to Illinois. There is thus no substance to a facial attack against the constitutionality of worldwide combined reporting.

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26. See Brief of Caterpillar Tractor Co. as *Amicus Curiae* in support of Appellee at 7-9.

27. Container relies upon hypothetical considerations and attacks the facial validity of worldwide combined reporting because it cannot carry its burden of proving that California's application of worldwide combined reporting taxed income that was not rationally related to California.

28. *See Supra* p. 5; *supra* notes 15, 23 & 25.

III. Container's Due Process Arguments Lack Merit Because Container Has Not Borne Its Burden of Proving by Clear and Cogent Evidence that California's Application of Worldwide Combined Reporting Taxed Any of Container's Extraterritorial Net Income

Container has offered no proof to establish that if it had not conducted any activities in California for the years in question what its net income would have been for those years. Neither has it otherwise proved any extraterritorial taxation by California. Rather, it erroneously assumes that its "separate accounting" analysis proves extraterritorial taxation by California's use of the combination method. While relying on its internal separate accounting to prove its case, Container admits that this separate accounting is not accurate.[29] This argument based on "separate accounting" begs the reasonable attribution question at issue. For, if Container and its foreign subsidiaries in fact conducted a unitary business for the years in question, separate accounting does not establish the invalidity of an apportionment result. *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).[30]

Notwithstanding the foregoing, in order to prove the validity of its "separate accounting" for its net profits and those of its foreign affiliates, Container argues that "[b]ecause combined apportionment on a worldwide basis fails to account for the lower wage rates and greater profitability of foreign operations" worldwide combined apportionment is invalid on its face and as applied to Container. Appellant's Br. at 15,

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29. *See supra* note 11.

30. The distortion in the attribution of income by the apportionment method as compared to separate accounting was far greater in *Exxon* and *Butler Bros.*' than any distortion claimed by Container to exist in this case. In *Butler Bros.*, the taxpayer contended that its California operations were operated at a loss of $82,851 and apportionment assigned a profit of $93,500 to California based on an apportionment of 8.1321 percent of the entire unitary income to California. This represents a difference of $175,000 or a shift of 15% of Butler Bros. net income between net income assigned to California by separate accounting and worldwide combination. In contrast, the average shift here is 2.28 percent.

11-18. It bases its "wage rates" argument (hereinafter referred to as Container's "payroll" argument) on its erroneous assumptions that: (1) "[c]ombined apportionment under the unitary method assumes that a dollar of property, payroll or sales of the parent (Container) produces approximately the same amount of income as a dollar of property, payroll or sales of a subsidiary" (*id.* at 11); and (2) under UDITPA, one-third of net income is attributable "upon the basis of payroll costs" (*id.* at 14). However, apportionment under the unitary method is based on the assumptions that: (1) the net income of a unitary business cannot be realistically divided by "separate accounting" to any particular costs, properties or activities; and (2) it is reasonable to attribute net income to where the business of the taxpayer is conducted as reflected by a composite result of all the factors of an apportionment formula. Thus, UDITPA assumes that the attribution of net income of a business in reference to the location of a taxpayer's sales, payroll and tangible properties *as an average* is a reasonable rough approximation for the geographical distribution of this net income. The fact that the factors are equally weighted for this purpose does not mean that one-third of net income is attributable to each factor.

Also, an attack on one factor of an apportionment formula does not prove the invalidity of the apportionment result.[31] For example, if property values are higher in a foreign area like Hong Kong or Western Europe, based on Container's theoretical "payroll" argument, the property factor would misapportion net income overseas. The same is true with the sales factor. In fact, California is not constitutionally required to use a payroll factor to apportion net income and could have used a single sales factor formula (*Moorman*) or a single property factor formula (*Underwood Typewriter*).

Container's argument in regard to higher expected (not actual) rates of returns of U.S. MNCs on investments in foreign countries, Appellant's Br. at 14, is also defective. As

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31. *See Norfolk & Western Ry. v. North Carolina*, 297 U.S. 682, 688 (1936); *American Cement Corp. v. Graves*, 299 U.S. 517 (1936).

applied to Container, this argument is specifically refuted by the fact that three of its foreign subsidiaries operated at a loss in 1963, four in 1964 and one in 1965. Exhibit A at 1, 3, 5. Expected profits and profits received are separate and distinct factual issues.

Further, Container's distortion argument is not internally consistent. For, if the enormous claimed payroll and profitability distortions were actually reliable predictors of alleged misapportionment (Appellant's Br. at 12-14), the resulting alleged extraterritorial taxation would be *many* times greater than that claimed by Container on pages 16-18 of its brief. For example, while Container asserts that its payroll costs in foreign countries are many times less than its payroll costs in the United States (*id.* at 12-13) and its operations in foreign countries are many times more profitable than in the United States, it claims an actual distortion of $4,000,000 (Appellant's Br. at 17). Using Container's numbers (*id.*), this figure represents only a 14% difference between its separate accounting "net profits" and worldwide combination. This $4,000,000 difference is simply based on the difference of its "separate accounting" for its net profits and that of its subsidiaries for federal tax information purposes as set forth on Container's IRS forms 2952s for the years in question. These net profit figures do not represent the net profits on which any income taxes are computed by any country of the world.[32] Thus, the table on

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32. Form 2952 is an information form filed with the Internal Revenue Service as part of the federal tax return of U.S. MNCs. This form is not used to compute any tax liabilities for any taxing jurisdiction and does not purport to accurately reflect any figures appearing thereon either in regard to the net profits or income tax liabilities of the taxpayer or its foreign affiliated corporations. *See supra* p. 7. (JA at 83-85). However, information on Container's 2952s for the tax years 1963, 1964 and 1965 was used to prepare Exhibit A (JAE at 1-6). The net profits disclosed in the 2952s were presumably determined by reference to generally accepted accounting principles which vary from country to country (JA at 83-85) and which differ from net taxable income as determined by various countries in which Container's subsidiaries operate. (*Id.*). Thus, these net profit figures must be treated as guesses or rough estimates. These net income figures hardly validate the *de minimis* misapportionment of net income upon which Container relies in this case.

table on page 17 of Container's brief does not prove distortion or double taxation.

Furthermore, these figures and those on page 16 of Container's brief do not correctly compare Container's U.S. source net income for federal income tax purposes with its U.S. source net taxable income for worldwide combination purposes. This comparison can only be made by comparing Container's U.S. source federal net taxable income in Exhibit A at 7, with Container's worldwide combined net taxable net income which was apportioned to U.S. sources by California's use of combination (factor information is derived from Exhibit A at 1-6 and net taxable income figure from *Id.* at 7). This comparison reveals that Container's average U.S. source net taxable income (including Subpart F income and California additions, such as state income taxes and interest on government obligations, which are clearly U.S. source income) for the years in question is *$32,803,794*. Net income attributable to the U.S. under the California worldwide apportionment method is *$34,244,889*. This represents a difference of *$1,441,109* or an attribution of approximately *3.23%* more to U.S. sources than attributable to U.S. sources for federal income tax purposes. Since Container asserts that its separate accounting profit is 9.43% of its U.S. receipts (Appellant's Br. at 14), this represents an increase of *only three tenths of one percent* of Container's U.S. source receipts based on its admittedly inaccurate separate accounting.

Since only approximately 8% of worldwide income was apportioned to California, increased net income attributable to California is only *$115,289*. When this is multiplied by California's tax rate, the tax result is *de minimus*, particularly when California's net income tax is deductible for federal income tax purposes. Furthermore, if the foregoing adjustments take into account foreign source income which is included in federal taxable income and the difference between federal depreciation and California depreciation deductions, this slight difference disappears.

In sum, the record does not support Container's argument that worldwide combined reporting is unconstitutional on

its face or as applied. If Container is entitled to anything, it is apportionment relief[33] which it has not requested.

IV. Contrary To Its Argument,[34] Container Has Not Shown That California's Use of the Combination Method Results in the Taxation of Income That Was Also Taxed By Foreign Countries

Container asserts that "California is not only taxing income which has been *earned* in foreign countries under the system of allocation applied in those countries, California is taxing income which is, in fact, also *taxed* by the foreign countries in which Container's subsidiaries operate." Appellant's Br. at 21. This statement is not correct. Regarding the foreign countries in which Container's subsidiaries operated, the record fails to indicate (1) the allocation methods employed by the foreign countries; (2) the subsidiaries' actual net taxable income reported to those countries; and (3) taxes actually paid to those countries. Container has conspicuously failed to produce the actual tax returns filed by its foreign subsidiaries with foreign countries in which they operated for the years in question. One can only surmise that Container has failed to do this because this information would not have supported either its distortion or double taxation arguments. Rather, as discussed above, Container relies upon the net profit figures in Exhibit A at 1-6 which are taken from its IRS form 2952 which it filed for informational purposes with its federal tax returns. These net profit figures are *not* the net taxable income figures reported to foreign countries (JA ¶ 21 at 11-12) and they are not accurate (JA at 83-85). Furthermore, the taxes paid by the foreign subsidiaries to foreign countries as contained in Container's 2952s (reproduced in Exhibit A at 1-6) are not

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33. *See Hans Rees' Sons; Norfolk & Western Ry. See also* UDITPA § 18, Cal. Rev. & Tax Code § 25137, which provides for apportionment relief if a taxpayer can establish that the apportionment provisions do not fairly represent the extent of the taxpayer's business activities in the state. As demonstrated herein, Container has simply not carried its burden of proving that it is entitled to UDITPA § 18 apportionment relief.

34. Appellant's Br. at 21-26.

complete or accurate figures, neither are they based on the net profit figures contained in the 2952s.[35]

In any event, California has taxed only approximately 8% of the combined net income of Container and its subsidiaries and Container has not shown that more than 92% of this combined income has been taxed either by other states or by foreign countries.

Assuming *arguendo* that Container has demonstrated that there is some overlap in taxation between the method employed by California in determining Container's income apportionable to California and the methods used by foreign governments to tax Container's subsidiary corporations, this does not raise a foreign commerce clause issue. California only asserts tax liability against Container for its California activities. California tax is not imposed on and is no more associated with foreign commerce than the New York income tax in *Bass, Ratcliff & Gretton*. In *Bass* the taxpayer's apportioned income was derived in part from foreign activities. In Container's case, its income is derived solely from its domestic U. S. operations. When Container conducts a unitary business with its foreign subsidiaries, worldwide combination is simply a method used to determine its true net income which it derives from its U.S. business which it conducts in the taxing state. Container's argument that the

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35. As discussed above, the inaccuracy of the net profit and tax figures in Exhibit A is demonstrated by the fact that they disclose an average of $34,000 in pre-tax income to Italy and tax liability on the average of over $121,000 to Italy based on this profit or 356% of the $34,000 pre-tax net profit figure. *See supra* p. 7.

In spite of the foregoing, Container asserts that the tax figures reproduced on page 84 of the Joint Appendix and the net profits of its foreign subsidiaries, as set forth in Exhibit A at 1-6, establish that California taxes net income which has been taxed by Colombia and Venezuela according to the arm's-length principle *actually applied in those countries*. Appellant's Br. at 22-23. This statement is not supported by the record. Assuming *arguendo* that tax treaties were relevant, no tax treaties exist between the United States and these countries. Neither does the fact that Container filed returns with these countries (as set forth in JA ¶ 140 at 72) support this statement. Furthermore, the long footnote No. 11 on pp. 25-26 of Container's brief is not a source of proof.

attribution of any net taxable income to California which is not reflected in its own separate accounting is the taxation of extraterritorial income earned in foreign commerce is analogous to the taxpayer's argument in *Bass* that New York imposed a tax on extraterritorial foreign income by use of the apportionment method and to the taxpayers' arguments in *Exxon* and *Underwood Typewriter Co.* that extraterritorial domestic income was taxed under the apportionment method. However, in these cases the Court held that the apportionment of the net income of a unitary business was a valid means to determine instate net income. Thus, the instant case is clearly distinguishable from *Japan Line* where the property tax was imposed directly on foreign corporations' property used exclusively in foreign commerce.[36]

Thus, for the reasons set forth above and *supra* pp. 18-20 in reference to Container's distortion argument, Container has clearly not proved any "double taxation." And, as indicated at *supra* p. 13, this Court has refused to resolve "double taxation" claims based on theoretical and hypothetical considerations.

V. Substantial Evidence in the Record Supports the Lower Court's Holding That Container and Its Subsidiaries Conducted a Unitary Business Sufficient to Meet the Rational Relationship Test of the Due Process Clause[37]

The narrow constitutional issue before this Court is whether the lower court's holding that Container and its foreign subsidiaries conducted a worldwide unitary business

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36. For further consideration of the foreign commerce clause argument of Container and its *amici* see the *amicus* brief of the Multistate Tax Commission in the pending *CBI* case.

37. As discussed above, this brief will not consider the relevancy of the due process tests as discussed in *ASARCO* and *Woolworth*. *See supra* note 17. In addition, those decisions erroneously resolved a combination method issue (the issue here in *Container*) when the actual issue before the court was a unitary apportionment issue — whether dividend income received by an existing unitary business could be included in the business' apportionable income. *See supra* note 15. In the alternative, as demonstrated in Appellee's brief, this case is factually distinguishable from *ASARCO* and *Woolworth*.

is consistent with the due process clause. The due process clause provides a minimal protection to taxpayers, insuring that the "taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state."[38]

As stated by Professor Lathrop:

> The unitary business concept . . . is not the linchpin of apportionability. The linchpin of apportionability in the due process sense is whether the amount of net income attributed to the state has a rational relationship to the business activities carried on in that state for which the state has given benefits and can ask compensation in return.[39]

The reasonableness of the apportionment result, not the unitary business principle, is the ultimate due process test. *See Norfolk & Western Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968) (state property tax); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931) (state corporate income tax). In both of these cases the apportionment formula result was invalidated on due process grounds even though the formula only apportioned the unitary income or the unitary property values. To our knowledge, this Court has never invalidated a state income tax apportionment case based on the unitary business principle, except in *ASARCO* and *Woolworth* where a Petition for Rehearing is pending. *It cannot be overemphasized that due process is a result oriented test, not a method oriented test: regardless of the method employed, the crucial issue is whether the taxing result represents a taking of the taxpayer's property without due process of law.*

Although the resulting income attributed to California does not violate the due process clause because it is well within

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38. *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

39. Lathrop, *Due Process Considerations and the Apportionment of Dividend Income: A Dissent From the ASARCO and Woolworth Decisions*, 16 Tax Notes 1 at 3, 20 (July 5, 1982). See the *amicus* brief of Idaho and Utah, filed as a supplement to this brief.

rough approximation apportionment standards,[40] if required, the record supports California's factual decision to combine Container and its foreign subsidiaries into one unitary business.[41] From the states' perspective, the complex factual inquiries necessary to prove that a parent and its subsidiaries are subtly interwoven can present an administrative nightmare.[42] The needed facts are entirely in the possession and control of multinational corporate taxpayers at various locations around the world.[43] As illustrated by the record in

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40. See our response to Container's distortion argument in III. above at pp. 16-20.

41. In an effort to address the problem of what facts are necessary to determine which entities are engaged in a single trade or business, *see* Reg. IV.1(b), to the Multistate Tax Commission's UDITPA Allocation and Apportionment Regulations, which is reprinted in 7 Multistate Tax Comm'n Ann. Rep. 64, 65, App. J (1973-74).

42. In order to resolve these complex factual issues, Container suggests that this Court should adopt a due process standard of substantial flow of goods. Appellant's Br. at 47. We submit that this is a simplistic oversimplification of the problem.

43. When a taxpayer needs to prove that it engaged in a single worldwide unitary business, the taxpayer can easily produce the necessary facts to prove their business is a worldwide unitary business. For example, consider the thorough record established by Caterpillar Tractor Co. in the *CBI* case.

On the other hand, the difficulties faced by a state that needs to obtain the necessary facts from an uncooperative taxpayer cannot be overemphasized: the limited and overworked resources of the states are virtually no match for a large multinational corporation that decides to pursue a course of delay and judicial obstructionism. For example, consider the Multistate Tax Commission's protracted dispute with United States Steel Corp. The first round of this controversy lasted six years, required two district court opinions, and concluded with this Court's holding that the Multistate Tax Compact is Constitutional in *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978), *aff'g* 417 F. Supp. 795 (S.D.N.Y. 1976).

The second round of this controversy with U.S. Steel began in 1976 and is currently on appeal for the second time to the Ninth Circuit. In spite of three district court orders requiring U.S. Steel to produce the necessary relevant information, the matter remains stalled in the courts, and U.S. Steel continues to refuse to provide this information. *See generally Multistate Tax Comm'n v. United States Steel Corp.*, No. 1-76-182 (D. Idaho); *Multistate Tax Comm'n v. United States Steel Corp.*, 659 F.2d 931 (9th Cir. 1981); *Multistate Tax Comm'n v. United States Steel Corp.*, No. 82-3181 (9th Cir. Briefs submitted).

this case, the states are forced to rely upon stipulated records and cross examination of the taxpayer's witnesses to prove the necessary factual ties to support a combined report. Judicial presumptions should favor the states while also permitting corporate taxpayers to rebut the presumptions to establish that the states are taxing extraterritorial income.

Resolution of these presumptions revolves around how one views a Multinational Corporation (MNC). If a MNC is presumptively viewed as a single economic unit, "a cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy,"[44] then the taxpayer must shoulder the burden of proving that the result of a state's taxing method violates the taxpayer's due process rights.

Much has been written in regard to the fundamental nature of MNCs.[45] The following general description accords with common sense and business reality:

> Although MNC subsidiary corporations are legally separate, in fact MNC parents tend to view them as parts of the single global system whose overall success, rather than that of any individual component, is considered critical. From a business viewpoint, then, the

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44. Vagts, *The Multinational Enterprise: A New Challenge For Transnational Law*, 83 Harv. L. Rev. 739, 740 n.4 (1970) (quoting from Vernon, *Economic Sovereignty At Bay*, 47 Foreign Affairs 110, 114 (1968)).

45. *See* L. Solomon, *Multinational Corporations and The Emerging World Order* (1978); R. Vernon, *Storm Over The Multinationals - The Real Issues* (1977); R. Vernon, *Sovereignty At Bay - The Multinational Spread of U. S. Enterprises* (1971); M. Wilkins, *The Maturing Multinational Enterprise - American Business Abroad From 1914 to 1970* (1974); Vagts, *supra* note 44.

Professor Solomon states that "[a] decentralization ideology masks the reality of centralization, in which one corporate nerve center devised a common corporate strategy and made fundamental decisions regarding production, marketing, finance and research. Discipline and continuity were maintained through common training and coordination." L. Solomon, *Multinational Corporations and the Emerging World Order* 20 (1978).

> operations of the MNC largely transcend the geographic boundaries of the various nations of incorporation.[46]

In specifically analyzing the crucial issue of parental control, one author illustrates the broad spectrum of factual relationships that exist between MNC parents and their subsidiaries:

> A survey of the European subsidiaries and other units of 127 American corporations indicated that approximately 40% imposed single "strict" control, 40% evidenced "loose" control and 20% had control that was intermediate, flexible, undeterminable or in the process of being changed. A trend for stricter control was noted, stemming from three factors: the ease of communication and transportation; the development of the European Common Market, which resulted in the reorganization of distribution and marketing functions; and the growth and importance of the European subsidiaries as corporate profit centers. Other expert observers view control by American firms as declining over time as foreign affiliates gained experience.[47]

Unless this Court presumes (subject to clear and convincing proof to the contrary) that a single business exists when a MNC parent and its subsidiaries engage in the same line of business, this Court will be encouraging a multiplicity of suits to review innumerable degrees of factual MNC control relationships. Logic dictates that this Court should presume that MNCs in the same line of business are conducting a unitary worldwide business. Absent this presumption, the states will be faced with the insurmountable burden of making detailed complex factual inquiries of MNC taxpayers.

The facts in the case at bar affirm that a MNC parent, operating in the same line of business as its many foreign subsidiaries, is so inexorably intertwined with the subsidiaries' business affairs that the corporate cluster should be presumed to be acting like a single worldwide

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46. Note, *Multinational Corporations and Income Allocations Under Section 482 of the Internal Revenue Code*, 89 Harv. L. Rev. 1202 (1976).

47. L. Solomon, *Multinational Corporations and the Emerging World Order* 21 (1978).

business. Container's numerous admissions in the stipulated record support this presumption by clearly indicating that Container: (1) represented itself as a worldwide company, referred to its foreign operations as divisions, and referred to its foreign employees as its own employees in its 1963 annual report (Exhibit I); (2) engaged in the same line of business with all of its foreign subsidiaries except one (a holding company without tangible property or employees) (JA ¶ 25 at 14); (3) owned a controlling interest in all twenty of its foreign subsidiaries (JA ¶ 25 at 14-15, ¶ 10 at 7); (4) created and founded eleven of their foreign subsidiaries (JA ¶ 25 at 14); (5) studied and made recommendations on whether to create a new subsidiary or enter a new market (JA ¶ 28 at 16-17); (6) admitted that a majority of the positions on the boards of directors on over half of the foreign subsidiaries were held by non-local representatives. (Appellant's Br. at 3); (7) reviewed most of the subsidiaries' "major policy matters" (JA ¶ 74 at 39); (8) entered into detailed written contracts when permitted by local law, to provide an astounding range of technical services, information and personnel to its foreign subsidiaries,[51] including confidential information (JA ¶ 144 at 74, Exhibit F); (9) loaned money to its foreign subsidiaries (JA ¶ 133 at 69); (10) guaranteed loans made to its foreign subsidiaries

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48. These technical service agreements demonstrate that Container was inexorably intertwined in the business affairs of its subsidiaries. For example, consider Container's contract with its German subsidairy:

> II. BREMER PAPIER is engaged in the same industries as CONTAINER. In order to develop its business on the German market, BREMER PAPIER wishes to partake of the experiences accumulated by CONTAINER in the industries as referred to in Recital I hereof by requiring assistance of CONTAINER . . . .
>
> FIRST: CONTAINER binds itself to perform services and to provide advice and consultation to BREMER PAPIER concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting in accordance with CONTAINER's progress in these areas, and to render any other assistance which BREMER PAPIER may require in connection with any aspect of its industrial or commercial operations. (Exhibit F at 9-10).

Another example of broad spectrum of services that Container provided is the Contract with one of its Mexican subsidiaries:

(JA ¶ 133 at 70); (11) helped subsidiaries "in their acquisition of equipment and machinery" (JA ¶ 147 at 76); (12) assisted the foreign subsidiaries' purchase of equipment from independent suppliers" (JA ¶ 148 at 77); (13) sold "linerboard," "paperboard" and "raw materials" to its foreign subsidiaries (JA ¶ 141 at 73); (14) purchased paper for its foreign subsidiaries (JA ¶ 143 at 74); (15) entered into a joint venture with one Colombian subsidiary (JA ¶ 158 at 81); (16) assisted a foreign subsidiary's contract negotiations (JA ¶ 65 at 33); (17) made its design laboratories and design information (JA ¶¶ 66, 67 at 34-35) and its product information (JA ¶ 86 at 46, ¶ 92 at 49) available to its subsidiaries; (18) assisted the foreign subsidiaries to find qualified personnel (JA ¶ 89 at 48, ¶ 95 at 51); (19) trained key subsidiary personnel (JA ¶ 79 at 42); (20) demonstrated a specific machine or process, and discussed specific topics, with key subsidiary personnel (JA ¶ 108 at 55); (21) established "approximately 10-12 visits per year for 2-6 week periods by foreign employees to the United States to familiarize themselves with the methods of operation of CCA" (JA ¶ 131 at 69); (22) transferred employees to subsidiaries (JA ¶ 120 at 62); (23) paid the salaries of some employees of foreign subsidiaries (JA ¶ 124 at 64-65); (24) maintained a " foreign operations staff" (JA ¶ 126 at 65); (25) had three members of this foreign operations staff make "decisions regarding its foreign subsidiaries" and present

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Footnote 48 (con't)

> FIRST: Container binds itself to render Carton y Papel technical assistance for the efficient operation of the industrial plants referred to in Recital II hereof, for the efficient production of board and cardboard and corrugated shipping containers, as well as for any other similar activity that Carton y Papel may carry out in the future in Mexico. As a consequence of Container's obligation, Carton y Papel shall have the right to receive technical assistance as far as concerns the purchase of machinery and raw material, the supervision of production methods and the improvement of same in accordance with Container's technical progress, the information of such raw material or finished products markets as may be of interest to it, as well as any other assistance which it may require in connection with any aspect of its industrial or commercial operations. (Exhibit F at 20).

"studies and made recommendations to CCA's Management Committee and Board of Directors" (JA ¶ 129 at 67); (26) stipulated that its Director of Taxes and Insurance was thoroughly experienced with the subsidiaries' tax and financial affairs (JA at 83); (27) had 26 former employees working for the foreign subsidiaries (JA ¶ 120 at 62), at least ten of whom functioned at the corporate or division level (Exhibit D); (28) paid 38 employees who were employed by the foreign subsidiaries (JA ¶ 119 at 60); (29) had officers or employees serving on every subsidiary Board of Directors except one inactive subsidiary (Exhibit E); (30) had nine officers who also served on the Board of Directors of the foreign subsidiaries (JA ¶ 131 at 68); (31) had its accountant, Arthur Anderson & Co., audit all but two of its subsidiaries (JA ¶ 138 at 72); (32) had its insurance agent insure many of its foreign subsidiaries (JA ¶ 149 at 78); (33) had its general counsel devote 40% of his time to insure that the foreign subsidiaries conformed to "CCA's standards for professionalism, profitability and ethical practices" (JA ¶ 128 at 66); (34) developed accounting procedures to facilitate receipt of financial information (JA ¶ 136 at 71); (35) received monthly and yearly profit reports from the foreign subsidiaries (JA ¶ 135 at 71) because Container "worked toward achieving the most efficient systems and procedures possible" (JA ¶ 139 at 72); (36) reviewed the subsidiaries' budgets at its annual meeting (JA ¶ 134 at 70); and (37) had a special Management Committee that made quarterly reviews of the subsidiaries' capital projects (*id.*).

Because these numerous factual admissions support the lower court's holding that Container and its subsidiaries conducted a *de facto* single business, this Court should accept and affirm the trial court's findings of fact. *See Fry Roofing v. Wood*, 344 U.S. 157, 160 (1952); *Grayson v. Harris*, 267 U.S. 352, 358 (1925); *Portland Ry., Light & Power Co. v. Railroad Comm'n*, 229 U.S. 397, 412 (1913). These facts amply demonstrate that Container has thorough knowledge of, and was inexorably intertwined in the business affairs of all of its subsidiaries for the years in question. Although Container's brief characterizes its involvement with its

subsidiaries as occurring in "limited instances,"[49] nothing in the record indicates Container's above involvements were not absolutely essential to the business success of the plarent or its subsidiaries.[50] In resolving the question of whether Container's subsidiaries conducted independent discrete business enterprises, the decisive determination requires examination of the quality and character of Container's involvement in the affairs of its foreign subsidiaries, not examination of the mere frequency or quantity of their interactions. In any event, this involvement is sufficient to overcome Container's claimed violation of its due process rights, where, as in this case, the difference between Container's separate accounting and worldwide combination results are well within reasonable apportionment limits.

CONCLUSION

The record does not support Container's due process clause or commerce clause arguments that worldwide combined reporting is unconstitutional on its face, or as applied by California. Container is champion of no legal rights except its own. As an abstract theoretical proposition, Container cannot be denied due process of law or be subject to "double taxation." Worldwide combined reporting is not unconstitutional on its face. Worldwide combined reporting is constitutional as applied by California because Container failed to prove actual taxation of extraterritorial income. The controlling principle should be the reasonableness of the apportionment result, not the unitary business principle *per se*. Container has further failed to carry its burden of proof because ample evidence in the record supports the trial court's factual finding that Container conducted a unitary business with its foreign subsidiaries for the years in question. We therefore respectfully submit that this Court should affirm the judgment of the court below.

Respectfully submitted,
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49. Appellant's Br. at 5.

50. Taxpayers often argue that they provide services (such as those listed above) to protect their investments, not to control the operations of their subsidiaries. We submit that this distinction is illusory and incapable of definition.

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

**On Appeal From The United States Court Of Appeals
For The State Of California
For The First Appellate District**

BRIEF AS AMICUS CURIAE IN SUPPORT OF BRIEF OF APPELLEE FRANCHISE TAX BOARD

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TABLE OF CONTENTS

	Page
INTEREST OF THE AMICUS CURIAE	1
SUMMARY OF ARGUMENT	2
ARGUMENT	3
I. The Commerce Clause Does Not Over-ride The Reserved Taxing Power Of The States	4
II. It Would Be Contrary To The Public Interest To Create Further Incentives For Subterfuges Designed For The Concealment Of Taxable Income.	5
III. Discrimination May Arise As A Result Of Distinctions Between Classes Of Commerce.	6
IV. The California Tax Involved In This Case Does Not Discriminate	9
V. Fairness To Local Taxpayers Requires That Those Engaged In Interstate And Foreign Commerce Pay A Fair Share Of The Burdens Of Government.	11
CONCLUSION	14

TABLE OF AUTHORITIES

CASES: Page

Gibbons v. *Ogden*, 9 Wheat 1, 6 L. Ed. 23 (1824) 4

Boston Stock Exchange v. *State Tax Commission*, 429 U.S. 318 50 L. Ed.2d 514, 97 S. Ct. 599 (1977) . 4, 6, 7

Western Live Stock v. *Bureau of Revenue*, 303 U.S. 250, 82 L. Ed.2d 823, 58 S. Ct. 546 (1938) 4

Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274, 51 L. Ed.2d 326, 97 S. Ct. 1076 (1977) 4

Bass, Ratcliff & Gretton v. *State Tax Commission*, 266 U.S. 271, 69 L. Ed. 287, 45 S. Ct. 82 (1924) 4, 5

Mobil Oil Corp. v. *Commissioner*, 445 U.S. 425, 63 L. Ed.2d 510, 100 S. Ct. 1223 (1980) 4, 5

Dean Milk Co. v. *Madison*, 340 U.S. 349, 356, 95 L Ed 329, 71 S Ct 295 (1951) 7

Moorman Manufacturing Co. v. *Bair*, 437 U.S. 267, 57 L. Ed.2d 197, 98 S. Ct. 2340 (1978) 9

Michelin Tire Corp. v. *Wages*, 423 U.S. 276, 46 L. Ed.2d 495, 96 S. Ct. 535 (1936) 10, 11

Northwestern States Portland Cement Co. v. *Minnesota*, 358 U.S. 450, 3 L. Ed.2d 421, 79 S. Ct. 357 (1959) 12

MISCELLANEOUS:

Data reported under Public Law 95-460, Agriculture Foreign Investment Disclosure Act of 1978 8

Data reported by Bureau of Economic Analysis of the Department of Commerce 8

Hearing, Senate Foreign Relations committee "Tax Treaties." 9

Statement On Unitary Business Concept in "State Taxation of Interstate Business," 25 Tax L. Rev. 171, 205 (1970) 10

Statement of Secretary of the Treasury on report entitled "Taxation of Foreign Investment in U.S. Real Estate." (1979) 13

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BRIEF AS AMICUS CURIAE IN SUPPORT OF BRIEF OF APPELLEE FRANCHISE TAX BOARD

STATEMENT OF INTEREST

The FARMERS EDUCATIONAL AND COOPERATIVE UNION OF AMERICA, known and identified by long usage and custom as the NATIONAL FARMERS UNION, is an association of family-scale farmers and ranchers in the principal agricultural regions of the Nation.

National Farmers Union is a non-profit agricultural educational organization, founded in 1902 and incorporated in the State of Texas, with its national headquarters located since 1941 in Denver, Colorado.

National Farmers Union's membership consists of 350,000 farm and ranch families, with significant membership in about 20 states which have an immediate demonstrable interest in the case at hand.

Because the decision reached by this Court will not only determine the right of the State of California to continue to use the unitary apportionment system for establishing the amount of income subject to taxation, but will also similarly affect the taxing powers of more than twenty other states, who now use adaptations of that system, or other states which might choose in the future to adopt the unitary apportionment system, National Farmers Union views the matter as being of great significance to farmers of the affected areas.

This brief is filed with the written consent of both parties pursuant to Rule 28 of this Court.

SUMMARY OF ARGUMENT

The tax climate of the U.S. is already tilted in favor of foreign investors in the U.S., and in favor of the flight of capital of the nation's corporations into foreign investment, both trends being motivated by the prospect of tax avoidance.

To acquiesce in enlargement of the above discriminatory policy would create incentives for subterfuges designed for concealment of taxable income. The opportunity to attribute U.S. corporate profits on paper to foreign subsidiaries should not be encouraged by this Court.

The Commerce Clause of the U.S. Constitution does not override the reserved taxing power of the state governments.

Discrimination between domestic and foreign transactions cannot be distinguished from discrimination be-

tween types of interstate transactions. Both are governed by the same clause of the Constitution.

Invalidation of the California tax would result in discriminatory treatment based solely on geographic considerations.

Fairness to state and local taxpayers requires that those engaged in interstate and foreign commerce pay a fair share of the burdens of government.

The Court should affirm the judgment of the California Courts, sustaining the California tax in this case.

ARGUMENT

A ruling favorable to Container Corporation of America (CCA) in this case would have undesirable ramifications for state governments and legislatures, for domestic enterprises and ultimately for our society.

Farmers and rural residents and their communities would be adversely affected by such a decision.

It would be detrimental to the general welfare for this Court to create a clear and unjustifiable discrimination in favor of foreign commerce as against domestic interstate and intrastate commerce.

The tax climate of the United States federal government is already tilted in favor of foreign investors, allowing them to shield their earnings from taxation, and in favor of the flight of capital of U.S. corporations into foreign investment.

A decision in favor of Container Corporation of America would further exacerbate the situation.

The Commerce Clause Of The Constitution Does Not Over-Ride The Reserved Taxing Power Of The State Governments.

Article I, Section 8, Clause 3, the frequently-noted "Commerce Clause," grants to Congress the power "To regulate commerce with foreign nations, and among the several states, and with Indian tribes."

Amendment 10 to the Constitution decrees that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

The Courts have held that "The Commerce Clause does not, however, eclipse the reserved 'power of the States to tax for the support of their own governments' *Gibbons* v. *Ogden* 9 Wheat 1, 6 L Ed 23 (1824). . . . rather the clause is a limit on state power." *Boston Stock Exchange* v. *State Tax Commission* 429 U.S. 318, 50 L Ed2d 514, 97 S Ct 599 (1977).

"It is not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden." *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250 82 L Ed2d 823, 58 S Ct 546 (1938). "Taxes are sustained when they do not discriminate against interstate commerce." *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 51 L Ed2d 326, 97 S Ct 1076 (1977).

The fact that foreign commerce may be involved is irrelevant for purposes of state income tax. This Court has sustained state taxes which included so-called "foreign source" income in the apportionment base and foreign activities in the apportionment formula. *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271, 69 L Ed 287, 45 S. Ct 82 (1924), *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 63 L Ed2d 510, 100 S Ct 1223 (1980).

It Would Be Contrary To The Public Interest To Acquiesce In Discriminatory Policy, Thereby Creating The Further Incentive For Subterfuges Designed For The Concealment Of Taxable Income.

A decision of this Court to bar the use of the unitary apportionment system would have the effect of acquiescing in discrimination in favor of multinational corporations to the detriment of domestic corporations. It would interfere with the rights of the states to tax income which is earned, in part, in their respective states and also lead, undoubtedly, to a restructuring of business acitivity in order to avoid state taxes.

Such a decision would encourage multinational corporations to engage in a tax "shell game," doing what multistate corporations often did before the Uniform Act, namely, to assign their profits to jurisdictions which allow them to avoid or minimize tax liability. The opportunity to attribute U.S. corporate profits on paper to foreign subsidiaries or associates should not be encouraged by this Court.

Such a decision would enlarge tax loopholes for multinational corporations, increasing the burden on domestic corporations, and aggravating the fiscal predicaments of state governments.

The apportionment of unitary business income for state tax purposes has been recognized by the courts in numerous decisions, notably in *Bass, Ratcliff & Gretton, supra*, as cited in *Mobil Oil Corp. supra*, in which the Court declared that "The State was justified in attributing to New York a just proportion of the profits earned by this Company from such unitary business."

The states cannot exist without the independent exercise of their taxing authority. Neither are state's need

budgetted annually by the federal government, nor are state revenues raised by the federal government. Each jurisdiction must exercise its taxing authority to raise funds for its own needs and to carry out its own policies. This should be particularly obvious in a time when important financial responsibilities are to be transferred from the federal to the state level.

This Court, therefore, should not make a decision which would hamper the efforts of the states to tax equitably, uniformly and fairly, the income, which is attributable to activities within those states and to raise their own necessary revenues.

Discrimination Against Interstate Commerce Is Not Limited To Favoritism For Intrastate Commerce, But Also May Arise As A Result Of Distinctions Between Classes Of Commerce.

In *Boston Stock Exchange*, *supra*, the Court had occasion to analyze a state tax which refined the area of discrimination to encourage one type of interstate commerce as compared to an alternative. The Court held:

> "There has been no prior occasion expressly to address the question whether a State may tax in a manner which discriminates between two types of interstate transactions in order to favor local commercial interests over out-of-state businesses, but the clear import of our Commerce Clause cases is that such discrimination is constitutionally impermissible."

It follows that the same reasoning should apply to foreign commerce vis-a-vis interstate commerce. Discrimination between interstate and foreign transaction cannot be distinguished from discrimination between types of interstate transactions. Both interstate and foreign commerce are governed by the same clause of the Constitution.

"The prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Clause. Permitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects. *Dean Milk Co.* v. *Madison*, 340 U.S. 349, 356, 95 L Ed 329, 71 S Ct 295 (1951)." *Boston Stock Exchange, supra.*

Therefore, construing a state tax to discriminate in favor of foreign commerce with respect to interstate commerce should be equally impermissible.

Disallowing the use of the unitary apportionment system would have two unfortunate effects. First, it would tend to subsidize foreign investment in U.S. property, notably in U.S. agricultural land, by sheltering the profits of foreign investors from effective state taxation. Second, it would spur the flight of U.S. capital into foreign investments chiefly for tax avoidance.

These prospects cannot be taken lightly by National Farmers Union. An invasion of foreign capital into American agriculture would, in our view, be disruptive, indesirable and un-needed. Further, we contend, recent foreign acquisitions of U.S. farm land have been on an alarming scale.

More American farm land has come under foreign ownership and control in the past five years than in the preceding fifty years.

Fifty four percent of all farm land parcels owned or controlled by alien investors have been acquired since 1975. By value of farmland owned or controlled by aliens, the proportion acquired since 1975 is 75%.

Most recent data, reported under Public Law 95-460, the Agricultural Foreign Investment Disclosure Act of 1978, shows that the trend to foreign acquisitions accelerated in 1981. At the end of 1981, the farm acreage held by foreign investors was 62% larger than a year earlier. Foreign interests were involved in about one-fourth of the agricultural land transfers.

We are not contending that all investment by U.S. companies in foreign plants and subsidiaries or all investment by foreign companies in American plants and subsidiaries is undesirable. But, we do question such investment where its principal motivation is tax avoidance.

United States tax policy, in our view, must recognize the economic self-interest of the United States.

In the past two decades, U.S. policies have allowed tax-motivated decisions diverting investment capital into activities abroad at the expense of modernizing domestic plants. Thus, we now have aging plants and less competitive situations in steel, autos, electronics and other enterprises.

The Bureau of Economic Analysis of the Department of Commerce projects that capital expenditures by majority-owned foreign affiliates of U.S. companies will total $50 billion in 1982, an increase of 11% over a year earlier, following upon a 7% increase in 1981 and a 30% increase in 1980.

The same Bureau of Economic Analysis reported in April, 1982, that the total assets of U.S. multinational corporations have grown by an average of 11% a year in the past 12 years, with the growth rate higher for the foreign affiliates than for the U.S. parents. Total assets of these multinational firms now are nearing $2 trillion.

The California Tax Involved In This Case Does Not Discriminate Against Intrastate, Interstate Or Foreign Commerce.

The California tax involved in this case is an apportioned tax. The apportionment base includes all the income of the unitary business, and the apportionment formula includes all the apportionment factors of the unitary business. California applies the tax on a worldwide basis. It includes the income and activities of the foreign subsidiaries or divisions of United States-based businesses, and it includes the income and activities, wherever located, of foreign-based businesses. See *Hearings Before the Committee on Foreign Relations, United States Senate*, "Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Phillipines." No distinction is made on the basis of the location of the activities or the business.

CCA argues that the tax discriminates against businesses engaged in foreign commerce because foreign countries do not tax on an approtioned basis. The answer to this argument was provided by this Court in footnote 12 in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 57 L Ed2d 197, 98 S Ct 2340 (1978), where it stated:

> "The simple answer, however, is that whatever disparity may have existed is not attributable to the Iowa statute. It treats both local and foreign concerns with an even hand; the alleged disparity can only be the consequence of the combined effect of the Iowa and Illinois statutes, and Iowa is not responsible for the latter.
>
> "Thus, appellant's 'discrimination' claim is simply a way of describing the potential consequences of the use of different formulas by the two States. These consequences, however, could be avoided by the adoption of any uniform rule; the 'discrimination' does not inhere in either State's formula."

Invalidation Of The California Tax Because Of Foreign Commerce Considerations Would Create A Distinction Between Foreign Commerce And Interstate Commerce Which Would Result In Discriminatory Treatment Based Solely Upon Geographical Considerations.

If this Court should strike down the California tax here involved on the grounds that it is an interference with foreign commerce, it would be requiring the States to accord different tax treatment to similarly situated businesses solely on the basis of the location of the business. This proposition was rejected by this Court in *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 46 L Ed2d 495, 96 S Ct 535 (1976), with respect to ad valorem property taxes assessed against imported goods no longer in import transit.

> "By definition, such a tax does not fall on imports as such because of their place of origin. It cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot be applied selectively to encourage or discourage any importation in a manner inconsistent with federal regulation."

The same reasoning is applicable to State income taxes. The tax here involved is not selectively applied; it is uniformly applied. The commercial domicile or location of business activities is irrelevant for purposes of the application of the tax. For "[i]t seems clear, strictly as a logical proposition, that foreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment—in the case of a multistate business—involve the taxation of income arising in other states. In both situations the total

income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state." Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171, 205 (1970).

As a point of conjecture, consideration should be given to the effect of a decision invalidating the California tax on a foreign-based business which would have its tax reduced on the basis of the unitary business principle. Could a State successfully deny the use of the unitary method to such a corporation? It would seem not. A foreign corporation would appear to have a compelling argument to be allowed to opt for the unitary method under the nondiscrimination clauses of Friendship, Commerce and Navigation Treaties and conventions for the Avoidance of Double Taxation. If a State applies the unitary method to businesses engaged in interstate commerce, how can it discriminate against corporations in foreign commerce which request it. As the Court indicated "*encourage* or discourage." Does it matter that the selection is made by the taxpayer rather than by the State?

Fairness To Local Taxpayers Requires That Those Engaged In Interstate And Foreign Commerce Pay Their Fair Share Of The Burdens Of Government.

The Court said in *Michelin*, *supra*:

> "There is no reason why local taxpayers should subsidize the services used by the importer; ultimate consumers should pay for such services as police and fire protection accorded the goods just as much as they should pay transportation costs associated with those goods."

The same rationale applies with respect to income taxes.

In *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 3 L Ed 2d 421, 79 S Ct 357 (1959), the Court stated:

> "It is axiomatic that the founders did not intend to immunize such commerce from carrying its fair share of the costs of state government in return for the benefits it derives from within the State."

The Court should continue to honor this axiom and sustain the tax in this case. To do otherwise will require the States to either curtail services or increase levies upon solely intrastate taxpayers. Neither course is in the best interest of the States or their citizens.

National Farmers Union views this with gravity because the decision of this Court could directly affect the level of taxes payable by farm families if the lawful taxes now paid by foreign persons and corporations were to be substantially reduced.

Taxes paid by farm operator families are already at highly burdensome levels. In 1982, it is our projection that American farmers will pay about $16 billion in real estate, personal property and state and federal income taxes. The tax load may even exceed the total net income of U.S. farmers, now estimated to fall in the range of $14.5 to $18.5 billion.

If, due to either Court action or legislation, the unitary method of computing taxable income were to be disallowed, this would shift a substantial annual tax load, estimated at between $700 and $900 million from the foreign persons and corporations to state and local taxpayers. Since state sales and income levies are already at what many regard as scarcely-tolerable levels, the tendency would be for the revenue lost by the states to be sought largely from the property tax base. In many

states, agricultural land is an important part of that tax base.

In contrast, the tax burden imposed on the multinational corporations by the U.S. federal government and the several states is relatively light.

Because of concessional tax treaties and through the use of tax shelters, multinational corporations and foreign subsidiaries of U.S. corporations are able to minimize their tax liability under the U.S. federal income tax.

As an example, the letter of Secretary of the Treasury, W. Michael Blumenthal on May 4, 1979, to the Congress, transmitting a report, entitled "TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE," is instructive.

In this letter, Secretary Blumenthal observes that:

> "Under present law, capital gains realized by nonresident aliens and foreign corporations are not subject to U.S. tax unless they are 'effectively-connected' with a U.S. trade or business. The Treasury Report finds that foreign persons rarely incur capital gains tax on the disposition of their U.S. property holdings."

The Treasury Report acknowledges that the "U.S. exemption for gain on real property not effectively connected with a U.S. trade or business is unusual by international standards."

Further, the Treasury Report calculates that in 1979, the revenue lost by failure to tax capital gains on property sold by foreign investors amounted to about $276 million.

CONCLUSION

Nondiscriminatory treatment of interstate and foreign commerce requires that this Court sustain the right of the States to apply the unitary tax principle to all taxpayers over which nexus exists regardless of where their activities are conducted or where they are based. Fairness to wholly intrastate taxpayers requires that taxpayers engaged in interstate and foreign commerce pay their fair share of the cost of the governments from which they derive benefits.

Both goals can be served by sustaining the California tax in this case. The Court should affirm the judgment of the California Courts.

Respectfully submitted,

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CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

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BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION AND THE STATE OF HAWAII AS *AMICI CURIAE* IN SUPPORT OF THE *APPELLEE* FRANCHISE TAX BOARD

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TABLE OF CONTENTS

	Page
INTEREST OF THE AMICI CURIAE	1
SUMMARY OF ARGUMENT	8
ARGUMENT	10
1. The application of California's apportionment formula produces a fair allocation of *appellant's* income that is reasonably related to the *appellant's* activities conducted in California, and thereby yields a result well within the Court's due process standard	10
2. The Commerce Clause permits some overlapping in taxation of income	14
3. The use by *appellee* of the unitary apportionment method does not affect the ability of the United States' Government to speak with one voice in its foreign relations	19
CONCLUSION	22
ADDENDA	
FY 1983 First Budget Resolution, Federal Aid to State and Local Governments (Addendum A)	1a
Letter from Governor Lamar Alexander to the President (Addendum B)	2a
Letter from Governor Richard A. Snelling to the President (Addendum C)	4a
Letter from Governor Richard W. Riley and Governor Christopher S. Bond to Richard S. Williamson (Addendum D)	7a
Letter from Governor Allen I. Olson to Governor Richard A. Snelling (Addendum E)	9a
Letter from Governor Allen I. Olson to Larry G. Looney and Fred Muniz (Addendum F)	11a

TABLE OF CONTENTS—Continued

Page

Letter from Governor Richard A. Snelling to the Honorable Dan Rostenkowski (Addendum G) 13a

Letter from Governor Scott M. Matheson to the Honorable Dan Rostenkowski (Addendum H) 15a

Letter from Representative Peter W. Rodino, Jr. and Representative Don Edwards to the Honorable Dan Rostenkowski (Addendum I) 17a

Letter from U.S. Secretary of Labor Raymond J. Donovan to Governor Richard Snelling (Addendum J) 19a

TABLE OF AUTHORITIES

CASES: Page

ASARCO, Inc. v. Idaho State Tax Commission, —— U.S. ——, 50 U.S.L.W. 4962 (1982) 7, 17

Bass, Ratcliff & Gretton v. State Tax Commission, 266 U.S. 271 (1924) 10, 16, 17, 19

Butler Brothers v. McColgan, 315 U.S. 495 (1942) 11

Chicago Bridge & Iron Company v. Caterpillar Tractor Co., et al., Docket No. 81-349 (October Term 1981 but restored to the Calendar for re-argument) 2, 6

Exxon Corporation v. Wisconsin Department of Revenue, 447 U.S. 207 (1980) 11

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Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 16

Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980) 11, 14, 16, 17

Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) 15, 17, 18

Norfolk and Western Railway Company v. Missouri State Tax Commission, 390 U.S. 317 (1968) 12

Underwood Typewriter Company v. Chamberlain, 254 U.S. 113 (1920) 10

Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936) .. 17

F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico, —— U.S. ——, 50 U.S.L.W. 4957 (1982) 7

UNITED STATES CONSTITUTION:

U.S. Const. art. I, § 8, cl. 3 (Commerce Clause) .. 8, 9, 11, 14, 17, 22

U.S. Const. amend. XIV § 1 (Due Process Clause) 9, 10, 11, 22

UNITED STATES STATUTES AND LEGISLATION:

I.R.C. § 61 14

P.L. 97-34, The Economic Recovery Tax Act of 1981 4

TABLE OF AUTHORITIES—Continued

Page

H.R. 1983, 97th Cong., 1st Sess. (1981) 6, 7, 18, 19
H.R. 3982, 97th Cong., 1st Sess. (1981), enacted as P.L. 97-35, Omnibus Budget Reconciliation Act of 1981 4
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Budget of the United States, 1983, Special Analysis H, Federal Aid to State and Local Governments, Office of Management and Budget, Executive Office of the President (February 1982) 4
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G.A.O. Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving 2
Harley, *International Division of the Income Tax Base of Multinational Enterprise: A Treatise on the Unitary Business Concept*, Multistate Tax Commission (1981) 15
Income Tax Treaties (J. Bischel ed. 1978) 20

TABLE OF AUTHORITIES—Continued

Page

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Norr, Jurisdiction to Tax and International Income, 17 Tax L. Rev. 431 (1962) 14

Regional Growth, Historic Perspective, Advisory Commission on Intergovernmental Relations, Washington, D.C. (June 1980) 12

Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income, Multistate Tax Commission, Washington, D.C. (May 11, 1982) 2

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INTEREST OF THE *AMICI CURIAE*

The National Governors' Association and the State of Hawaii, pursuant to Rule 36.2 of the Rules of the Supreme Court of the United States, submit this brief as *amici curiae* in support of the *Appellee* Franchise Tax Board. General consent to the filing of *amici curiae* briefs, whether in support of the *appellant* or *appellee*, has been granted by each of the parties, and the letters of the parties evidencing such consent are lodged in the Office of the Clerk of this Court.

Amicus National Governors' Association is an incorporated instrumentality of the States, whose members are the chief elected officials of the fifty States, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, and the territories of the Virgin Islands, Guam and American Samoa. The National Governors' Association files this *amici* brief on behalf of all its members, and is specifically joined by the State of Hawaii.

There are thirteen States[1] which presently utilize the unitary apportionment method of State income taxation of multinational corporations with foreign subsidiaries on a world-wide basis. A number of other States are contemplating its use and are awaiting the decision of this Court in the instant case and in the case of *Chicago Bridge & Iron Company v. Caterpillar Tractor Co., et al.*, Docket No. 81-349 (October Term 1981 but restored to the calendar for reargument). The Multistate Tax Commission has found that a prohibition on the inclusion of foreign subsidiaries in the definition of a unitary multinational corporation would result in a loss of State revenues of not less than $625 million per year.[2]

A loss in State revenues could not come at a worse time. During fiscal year 1981 total State expenditures

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[1] The thirteen States are Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon and Utah. G.A.O. Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving, p. 31.

[2] Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income, Multistate Tax Commission, Washington, D.C. (May 11, 1982). The figures were the official estimates of the affected responding State tax departments. The figures do not include losses to Illinois, Indiana, Massachusetts, New Hampshire and Oregon. They also do not include losses due to increased transfer pricing or greater losses from foreign business expansion in future years.

exceeded revenues by a little over $5 billion. States made up the difference by drawing down balances from prior years. As a result, States finished the year with an aggregate balance of 4.5 percent, a figure less than 5 percent of expenditures, which some observers consider the financially prudent level. In fiscal year 1982 it was estimated that expenditures would again outstrip revenues, drawing down balances by about $4 billion, leaving an aggregate balance of 1.5%. For fiscal year 1983 it is estimated that deficits amounting to $1.8 billion will accrue, leaving the year-end balance at 1.1% of current year expenditures.[3] With an aggregate balance down to $2.4 billion, it will be impossible for States to repeat their FY 1982 performance of drawing down balances of over $4 billion. As a result, even without a loss from a possible prohibition on the world-wide application of "unitary" with regard to multinational corporations having foreign subsidiaries, many States face expenditure reductions, revenue increases or both to maintain budget balances.[4] The decreasing States' balances are dramatic. The number of State working days that could be funded from year ending balances, averaged for all States, has decreased from 11 days in fiscal year 1981 to 4 days in fiscal year 1982 to 3 days in FY 1983.[5]

The present recession, high unemployment rates, high interest rates, and high business failure rates have all contributed to putting substantial pressure on the finances of State governments. High unemployment and

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[3] *Fiscal Survey of the States, 1981-1982.* National Governors' Association and the National Association of State Budget Officers, Washington, D.C. (1982), p. 4. The 1981-1982 report is the eighth volume in the annual *Fiscal Survey of the States.*

[4] All States except Vermont have legal constraints against incurring deficits in their general operating budgets, and Vermont, like other states, has strong traditions favoring a balanced budget.

[5] *Ibid.* at p. 8.

slow wage growth adversely affect income tax receipts and at the same time increase pressures for additional spending for income support programs. The drop in farm income has adversely affected revenues in States where a high proportion of economic activity is related to agriculture, a good number of which are "unitary" States. Changes in federal tax law that were enacted last year [6] continue to affect negatively State finances and will do so throughout the 1980's. Federal budget cuts are also having a major impact on State revenues. Federal aid to State and local governments has been going down. Federal outlays peaked in fiscal year 1981, and in constant dollar terms crested in fiscal year 1978.[7] Long-term projections show a continuation of the downward trend.

At the same time State budgets have been under considerable financial strain, States are being asked under "New Federalism" to assume a greater amount of responsibility for programs once administered by the federal government. In 1981 Congress, as part of the "Omnibus Budget Reconciliation Act of 1981," [8] enacted nine block grants.[9] In his 1982 budget message, President Reagan called for the devolution of 44 federal programs to be ad-

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[6] P.L. 97-34 entitled "The Economic Recovery Tax Act of 1981."

[7] See Addendum A. The National Governors' Association is the source of this chart. It is based on *The Budget of the United States Government, 1983, Special Analysis H, Federal Aid to State and Local Governments*, Office of Management and Budget, Executive Office of the President (February 1982); and Congressional Budget Office estimates.

[8] H.R. 3982, 97th Cong., 1st Sess. (1981), enacted as P.L. 97-35.

[9] Those nine block grants are: a) Alcohol, Drug Abuse and Mental Health Block Grant, b) Community Development Block Grant, c) Community Services Block Grant, d) Elementary and Secondary Education Block Grant, e) Home Energy Assistance Block Grant, f) Maternal and Child Health Care Block Grant, g) Preventive Health Services Block Grant, h) Primary Care Block Grant, and i) Social Services Block Grant.

ministered by the States.[10] Clearly, if States are to have the financial capacity to assume the turnback of greater program responsibilities from the federal government, States must have the resource base to pay for those programs.

The National Governors' Association is concerned with preserving the State income tax revenue base. That concern is reflected in the membership adopted policy position B.-5 entitled "Avoiding Federal Preemption of State Laws and Policies." It reads in part:

> The Constitution assigns certain responsibilities to the federal government and reserves the balance for the states. Accordingly, the role of the federal government in areas reserved for states and local governments should be strictly limited. . . .
>
> Integral to the operation of state government is the freedom to structure state revenue systems. It is essential that the federal government not preempt, either directly or indirectly, sources of state revenues, state tax bases or state taxation methods.[11]

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[10] *Budget of the United States Government, Fiscal Year 1983*, Office of Management and Budget, Executive Office of the President (February 1982), pp. 3-28 through 3-31; and *Major Themes and Additional Budget Details, Fiscal Year 1983*, Office of Management and Budget, Executive Office of the President (February 1982).

[11] National Governors' Association Policy Position B.-5 was adopted in August 1980 and amended in August 1982. The text accompanying and supporting the 1982 amendment read:

> This proposed policy position would amend existing NGA policy on federal preemption to clarify that NGA's position includes protection of a state's authority to structure its own revenue system. Existing NGA policy position B.-5 provides generally that federal preemption should be avoided. It does not reference state taxation. While NGA has relied on the general preemption language in the past, specific policy language would be helpful to NGA in addressing such revenue issues as the proposed increases in federal excise taxes, the imposition of federal minimum corporate and individual taxes affecting the

In furtherance of the National Governors' Association policy on preemption, and to retain the States' option to utilize on a world-wide basis the "unitary apportionment method" of taxing multinational corporations with foreign subsidiaries, Governor Alexander on behalf of the Association wrote to the President on February 25, 1982 [12] seeking the withdrawal by the Solicitor General of the federal government's brief in the *Chicago Bridge and Iron* case [13] and the Administration's opposition to H.R. 1983 and S. 655.[14] The matter was pursued further by Governor Snelling who wrote to the President on August 3, 1982 [15] prior to the meeting of the President's Cabinet Council on Economic Affairs at which the "unitary apportionment method" was to be discussed. Subsequent to the meeting of the Cabinet Council on Economic Affairs held on August 6, 1982, Richard S. Williamson, Assistant to the President for Intergovernmental Affairs, announced on August 8, 1982 at the National Governors' Association annual meeting that the Administration was opposed to any amendment to the pending comprehensive tax bill,

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deductibility of state and local taxes and interest from tax exempt bonds, and the states' use of the unitary apportionment method.

The proposed policy position calls for neither an increase nor a decrease in federal or state revenues. Rather, it would permit states to continue to have the flexibility to choose appropriate sources of revenue and methods of obtaining it.

[12] See February 25, 1982 letter from Governor Lamar Alexander to the President (Attached hereto as Addendum B).

[13] *Chicago Bridge & Iron Company v. Caterpillar Tractor Co., et al.*, Docket No. 81-349 (October Term 1981 but restored to the Calendar for reargument).

[14] H.R. 1983, 97th Cong., 1st Sess. (1981) and S. 655, 97th Cong., 1st Sess. (1981).

[15] See August 3, 1982 letter from Governor Richard A. Snelling to the President (Attached hereto as Addendum C).

H.R. 4961,[16] which would prohibit the States' use of the "unitary apportionment method" and the Administration would take no position on H.R. 1983 and S. 655.[17] Significantly, at the Cabinet Council meeting no department represented requested a filing of an *amicus* brief in this case by the Solicitor General. Therefore, it is not surprising to note that an *amicus* brief from the Solicitor General is absent in this case.

The National Governors' Association, joined by the State of Hawaii, seeks to preserve to the States the right to fairly apportion income taxes among multinational concerns doing business in the States in return for the opportunities, benefits and protections those States have afforded or provided those corporations. To achieve this objective the National Governors' Association Committee on Legal Affairs recommended to the Association's Executive Committee that the Association file an *amicus curiae* brief on behalf of the *appellee* Franchise Tax Board.[18] The Executive Committee approved the filing of the brief.

The Association is also concerned with the impact of the recent Court decisions of *ASARCO, Inc. v. Idaho State Tax Commission*[19] and *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*.[20] These decisions impose unreasonable and unrealistic Constitutional restrictions on the taxing powers of the States. They hamper their ability to tax realisti-

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[16] H.R. 4961, 97th Cong., 2nd Sess. (1982), enacted into law as P.L. 97-248 entitled the "Tax Equity and Fiscal Responsibility Act of 1982".

[17] See September 2, 1982 letter from Governor Richard W. Riley and Governor Christopher S. Bond to Richard S. Williamson (Attached hereto as Addendum D).

[18] See July 15, 1982 letter from Governor Allen I. Olson to Governor Richard A. Snelling (Attached hereto as Addendum E).

[19] —— U.S. ——, 50 U.S.L.W. 4962 (1982).

[20] —— U.S. ——, 50 U.S.L.W. 4957 (1982).

cally income from intercorporate dealings in, and ownership of, intangibles. These intangibles annually amount to tens of billions of dollars. Under these decisions, this income can be apportioned only in those circumstances where it is logically treated as the profits of the payors of the income. For this reason, these decisions undercut the ability of the States to tax this income at all, if they could otherwise reasonably do so by resort to local fictions, such as the legal or commercial domicile of the corporate owners of the intangibles. They further erode a reasonable application of the unitary business principle by unduly restricting what constitutes a unitary business to meet due process "combined reporting" standards. This is demonstrated by *appellant*'s reliance on these decisions to support its argument that it did not conduct a unitary business with its subsidiaries. If these decisions are not reconsidered and this Court should conclude in this case that world-wide combination is prohibited by the Commerce Clause, the States clearly will be unable to tax effectively and fairly the profits of large multinational corporates that can shift their profits through a myriad of affiliated corporations anywhere in the world. As a result, the National Governors' Association supports the States of Idaho and New Mexico in their petitions for rehearings in the aforementioned cases.[21]

SUMMARY OF ARGUMENT

The Court should employ the same standards for examining a State's use of the unitary apportionment method for determining the income earned within that State by a domestic multinational corporation, without regard to whether the corporation is involved in interstate or foreign commerce.

The *appellee's* application of the apportionment formula to *appellant* yielded a result that roughly approximated the corporation's income that related to its activities

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[21] See September 21, 1982 letter from Governor Allen I. Olson to Larry G. Looney and Fred Muniz (Attached as Addendum F).

within the State of California. The wage differentials in the countries in which *appellant* did business were consistent with the wage differentials found in the United States when the formula apportionment method was designed. The net effect of averaging the differences in wage rates in the countries in which *appellant* carried on its business is to reduce possible distortions in the application of that formula factor. The three factor formula further reduces the significance of disparities in any single factor.

If there was any multiple taxation, it resulted either from extraterritorial application of foreign countries' taxes or from conflicting taxing methods of the *appellee* and foreign countries. If it was the former, then *appellee* should be able to require that the domestic corporation bear its fair share of the State tax burden. If it was the latter, then this Court should accept some *de minimis* multiple taxation. To the extent any such overlapping of taxation is possible and should be prevented, the *appellant* should look to Congress and not this Court for remediation.

America's foreign policy permits States to apply the unitary apportionment method to domestic multinational corporations with foreign subsidiaries on a world-wide basis. International law does not address how a country should tax its domestic corporations. There is no international custom that establishes arm's length as the international legal standard. And there have been no international repercussions to the States' application of the unitary apportionment method to domestic multinational corporations. If a change is to be made to our extant foreign tax policy, the *appellant* should look to Congress for relief.

This Court should find that *appellee* violated neither the Due Process nor Commerce Clause, and, therefore, the Court should affirm the decision of the Court of Appeal of the State of California.

ARGUMENT

The issue of whether the States have the authority to require United States multinational corporations with foreign subsidiaries to pay their fair share of State tax burdens is the question before the Court. In the instant case the *appellee* Franchise Tax Board has applied the same unitary apportionment method to *appellant* that it and forty-two other States use in interstate commerce. The Court has repeatedly approved its application in interstate commerce and should approve its application to domestic multinational corporations in foreign commerce as well because the constitutional principles are indistinguishable.

1. The application of California's apportionment formula produces a fair allocation of *appellant's* income that is reasonably related to the *appellant's* activities conducted in California, and thereby yields a result well within the Court's due process standard.

In the nineteenth century States used apportionment formulas to allocate property fairly for the purpose of determining the appropriate amount of property taxes of multistate corporations. Not long after States began imposing corporate income taxes in the early part of the twentieth century, they began apportioning income of unitary businesses by formula. Initially, a single property factor comprised the ingredient of the formula. In the case of *Underwood Typewriter Company v. Chamberlain*,[22] decided in 1920, the Court found constitutional the apportionment of income of a domestic corporation based on a property allocation formula. In 1924 this Court in *Bass, Ratcliff & Gretton, Limited, v. State Tax Commission*[23] found that an apportionment of income of a foreign-owned corporation based on a formula with property as the single factor neither violated the due

[22] 254 U.S. 113 (1920).

[23] 266 U.S. 271 (1924).

process clause nor imposed an unconstitutional burden on foreign commerce. When, however, the Court found the application of the constitutionally valid formula with the single property factor had an unreasonable and arbitrary impact, it declared the circumstances worked an unconstitutional result.[24] To avoid future unreasonable applications, States developed and began using formulas with more than one factor. One of those formulas, and the one in most prevalent use today, is a three part formula comprised of property, payroll and sales factors. The formula based on these three factors has been consistently upheld by this Court since *Butler Brothers v. McColgan*[25] and most recently in *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*[26] and *Exxon Corporation v. Wisconsin Department of Revenue*.[27]

The question, therefore, is not on the validity of the three part formula based on property, sales and payroll factors, but rather on the result of the application of the formula to *appellant*, a unitary corporation as determined by the California Court of Appeal and assumed *arguendo* by the *appellant*.

This Court has said that the application of formulary apportionment need only achieve a *rough approximation* of the corporation's income that is reasonably related to the activities conducted within the taxing State.[28] This Court, therefore, should uphold the application of the formula to *appellant* if the tax assessed is not out of all proportion to the business transacted in the State[29] and

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[24] *Hans Rees' Sons, Incorporated v. North Carolina*, 283 U.S. 123 (1931).

[25] 315 U.S. 495 (1942).

[26] 445 U.S. 425 (1980).

[27] 447 U.S. 207 (1980).

[28] *Ibid.* at p. 223 (emphasis added).

[29] *Hans Rees' Sons, Incorporated, op. cit.* at p. 135.

the application has not been proven by the taxpayer to lead to a grossly distorted result.[30]

The *appellant* attempted to show that the three part formula distorts the income attributed to California because wage rates are higher in California than in foreign countries. *Appellant* compared wage rates of Columbia and Venezuela, two developing countries with low wage rates in which it does business, with wage rates in the United States. While the wage rate differentials were significant in the examples of the two developing countries chosen, they are not very different from the wage differentials found in this country between 1900 and World War II, the period of time when the formula apportionment methods were devised. In 1900 the regional per capita income as a percent of the U.S. average varied from a low of 47.8% in the Southeast to a high of 162.9% in the Far West, a ratio of almost 1:4.[31] In terms of total yearly wages per wage earner in manufacturing establishments in 1909, South Carolina's average was $274 compared to $962 in Nevada, a ratio of about 1:3.5. In 1929 the extremes ranged from South Carolina's $659 to Wyoming's $1,646.[32] These large wage differentials have not persisted within the United States. Regional wage differences have lessened over time.[33] One should expect that large wage differentials between developed and developing countries will not be permanent and will also narrow over time as businesses increase operations in lower wage sites, thereby driving up labor costs. There is nothing inherent in foreign commerce to distinguish the

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[30] *Norfolk and Western Railway Company v. Missouri State Tax Commission*, 390 U.S. 317, 326 (1968).

[31] *Regional Growth, Historic Perspective*, Advisory Commission on Intergovernmental Relations, Washington, D.C. (June 1980), Table 1, p. 11.

[32] *Ibid.*, at pp. 132-133, Table A-15.

[33] *Ibid.*, at p. 45, Table 25.

early wage differentials in the United States from present wage differentials between developed and developing countries.

During the disputed tax years in question, *appellant* controlled 20 subsidiaries in Western Europe and Latin America.[34] In addition to subsidiaries in Columbia and Venezuela, it also controlled at least one subsidiary in Germany where according to *appellant's* brief it required $3.95 in payroll costs compared to $3.34 in payroll costs in the United States to produce $1.00 of net income.[35] From *appellant's* brief one can conclude that there was a wide range of wage scales in countries in which *appellant* was doing business, ranging from developing countries where wage rates were considerably lower to Western European countries where wage rates were higher than the United States. *Appellant* has not shown what distortion it claims is due to wage rate differentials in all parts of the world in which it conducts business.

The test of whether the application of the three factor apportionment formula so distorts the allocation of income of "unitary" *appellant* as to make its use unconstitutional should be an examination of how the application of the formula to the domestic corporation and all its foreign subsidiaries combined operates, not how it operates on one foreign subsidiary alone. Averaging wage costs among all of *appellant's* foreign subsidiaries produces a result well within constitutional standards. In a truly unitary enterprise, the differing economic values existing in varying geographic areas do not distort the apportionment.

Payroll expenditures is only one of the three factors in the formula for apportionment. The three factors operate synergistically. *Appellant* has the burden, there-

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[34] *Appellant's* brief, Appendix A at p. A-2.

[35] *Appellant's* brief at p. 18.

fore, of showing not only that one factor presents potential problems, but that the three factors working together distort the allocation of income so badly that it assesses *appellant* wholly out of proportion to business transacted in California. *Appellant* has not overcome that burden.

2. The Commerce Clause permits some overlapping in taxation of income.

In the instant case the *appellee* Franchise Tax Board utilized a fair and accepted method of apportioning income of unitary *appellant*.[36] As applied by *appellee*, the formula apportionment only related to the activities conducted in the State of California by *appellant*,[37] and it did not tax income earned in any other jurisdiction.

Appellant asserts in its brief that it filed returns and paid taxes in compliance with the laws of the respective countries in which it did business.[38] However, there is no indication whether the laws of those countries restrict their jurisdiction to the taxation of income based on activities conducted within their borders. This is more than an academic question since the United States, for example, asserts world-wide taxing jurisdiction under Internal Revenue Code § 61.[39] Thus, if any multiple taxation has occurred, it may be the result of foreign countries asserting jurisdiction to tax income which was earned in the State of California.[40] One or more of those

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[36] See *Mobil, supra* at footnote 26.

[37] See point 1 of the Argument.

[38] *Appellant's* brief at p. 25.

[39] The United States tries to minimize the opportunity for double taxation by having available for foreign tax payers a foreign tax credit system.

[40] "A country is free to adopt whatever rules of tax jurisdiction it chooses. This is true no matter how broad may be the reach of the resulting tax net." Norr, Jurisdiction to Tax and International Income, 17 Tax L. Rev. 431 (1962).

foreign countries may have taxed income earned in California even though multiple taxation resulted. According to Geoffrey John Harley:

> There is no domestic or international law, treaties aside, which holds double taxation to be legally impermissible. Subject to any constitutional constraints, a jurisdiction can tax as it chooses.[41]

If the present case is an instance of a foreign country taxing income earned in California and California taxing that same income, should California give way? We think not. California is well within its constitutional rights to tax income earned within its borders even if multiple taxation results because a foreign country has applied its tax extraterritorially. The Constitution confers no immunity from State taxation, and foreign commerce must bear its fair share of the State tax burden.

It may be that any multiple taxation that occurred as a result of California's use of the "unitary apportionment method" and a country's use of the "arm's length method" resulted either from clashes between the two systems or definitional differences. However, so long as the overlap is small, it represents a *de minimis* situation. This Court, as it expressed itself in *Moorman Manufacturing Co. v. Bair*,[42] clearly understands the problems which arise when two taxing authorities do not use identical rules for the division of income. These problems exist not only when the taxing methods are different, but when they are the same. Differences within similar systems extend from definitions, rates and concepts to the treatment afforded corporations which receive income from extra-territorial operations. These differences mean that there are usually two potential claims to tax—in the

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[41] Harley, *International Division of the Income Tax Base of Multinational Enterprise: A Treatise on the Unitary Business Concept*, Multistate Tax Commission (1981), p. 162.

[42] 437 U.S. 267 (1978).

instant case California and a foreign country. Even if both California and the foreign country had used the "unitary" method or both had used the "arm's length" method, a similar overlap might well have resulted. Therefore, the use of the "unitary" method with regard to the taxation of multinational corporations with foreign subsidiaries by California should not be in question.

The *Appellant* relies on *Japan Line, Ltd. v. County of Los Angeles*[43] for the principle that where a country, in that instance Japan, had the right to tax fully an instrument of foreign commerce, California's tax, a fair property apportionment tax, of that same instrumentality had to give way. However, in *Mobil* the Court was careful to distinguish the principles of property taxation from those of income taxation.[44] In the *Japan Line* case, Japan had fully taxed Japanese companies on instrumentalities utilized exclusively in foreign commerce; California was trying to levy a tax on those same instrumentalities. In the instant case California is attempting to tax neither instrumentalities of foreign commerce nor a foreign corporation. Rather, it is taxing a domestic entity incorporated in Delaware with headquarters in Illinois for income earned in California and with which California has nexus.

Appellant is wrong in relying on the *Japan Line* case. It should look to *Bass, Ratcliff & Gretton, Limited, v. State Tax Commission.*[45] Once the *appellant* is found to be a "unitary" corporation, the principles of *Bass* apply. In *Bass* this Court upheld New York State's apportionment of the entire income of an English corporation to determine the appropriate amount of income earned in New York. To apply *Japan Lines* to the instant case is to

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[43] 441 U.S. 434 (1979).

[44] 445 U.S. at p. 448.

[45] 266 U.S. 271 (1924).

overrule *Bass*,[46] which would eliminate a longstanding distinction this Court has made between taxation of instrumentalities of commerce and taxation of income.[47]

If the *Court* is not going to accept some *de minimis* overlap in taxing by two jurisdictions, then the Court must be willing to involve itself in extensive judicial rule-making.[48] If the Court is unwilling to establish a uniform rule of apportionment in the case of interstate commerce when it has jurisdiction over all the parties, why is it more willing to do so when one taxing authority is beyond the Court's reach? Even if it so desires, this Court does not have the power to establish an international uniform rule for the division of income to which all countries will agree.

This Court has said that in the case of the use of the "unitary apportionment method" of taxation of companies involved in interstate commerce, Congress is the right tribunal to which the parties should turn to achieve uniformity in formulas. Congress is also the proper forum to achieve uniformity in the case of foreign commerce. This Court said in *Moorman*:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to all the interests of all the affected States. It is clear that the legislative powers granted to Congress by the Commerce Clause of the Constitu-

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[46] This court cited *Bass* favorably only two years ago in *Mobil*, 445 U.S. at pp. 438 & 439, and only last term in *ASARCO, Inc. v. Idaho State Tax Commission*, —— U.S. ——, slip opinion at p. 12, footnote 14, and p. 21 (1982).

[47] See *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 202 (1936).

[48] See *Moorman, op. cit.*, 437 U.S. at p. 278.

> tion would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body and not this Court, that the Constitution has committed such decisions.[49]

Congress has not been passive or silent with regard to the case of the "unitary apportionment method" for taxing multinational corporations with foreign subsidiaries. It has had made explicit decisions to continue to permit States to utilize it. When the United States/United Kingdom tax treaty was debated in the Senate, the issue of applying combined reporting to unitary multinational corporations was raised. The Senate refused to ratify the treaty until Article 9(4) prohibiting the use of the "unitary apportionment method" was removed.[50] Presently H.R. 1983 and S. 655, which raise the same issue, are before the Congress.[51] It was raised this summer during the consideration of H.R. 4961.[52]

In summary, if multiple taxation has occurred, it may be the result either of foreign governments taxing income earned in California or of California and foreign countries having conflicting taxation methods. In either case, we contend that this Court is not the proper tribunal to remedy the problem. The Administration and Congress working together are the appropriate branches of government to resolve the political and international relations issues involved.

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[49] Ibid. at p. 280.

[50] See *Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, As Amended*, S. Exec. Rep. No. 96-5, 96th Cong., 1st Sess. (June 15, 1979).

[51] See footnote 14 *supra*.

[52] See footnotes 15, 16 and 17 *supra* and Addenda G, H & I.

3. The use by *appellee* of the unitary apportionment method does not affect the ability of the United States' Government to speak with one voice in its foreign relations.

The unitary formula apportionment method applied by the State of California does not contravene any specific United States treaty or statute; for if it had, *appellant* would have so argued. The gravamen of *appellant's* argument is that the employment of the unitary method is in conflict with general federal policy, and thereby prevents the United States from speaking with one voice.

However, the general policy of the federal government over the last sixty years has been to allow States to use the unitary apportionment method. The issue of whether to permit States to use "formula apportionment" in the foreign commerce context has been raised in court cases, legislation and treaties and always been explicitly resolved in favor of the States. In the case of *Bass*, the *appellant* English firm of Bass, Ratcliff & Gretton argued that the application of formula apportionment to it constituted a burden on foreign commerce.[53] This Court rejected that theory.[54] It was also argued in Congress during the course of debate over numerous bills, the most recent of which were H.R. 1983, S. 655 and H.R. 4961.[55] The Administration, Congress and the States have all been involved in those debates.[56] No bill restricting the

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[53] 266 U.S. 271 (1924), Appellant's brief at p. 39.

[54] 266 U.S. 271 (1924).

[55] See footnotes 14 and 16 *supra*.

[56] See Addendum B; Addendum C; and Addendum D. Also see July 19, 1982 letter from Governor Richard A. Snelling to the Honorable Dan Rostenkowski (Attached hereto as Addendum G); July 21, 1982 letter from Governor Scott M. Matheson to the Honorable Dan Rostenkowski (Attached hereto as Addendum H); July 20, 1982 letter from Representative Peter W. Rodino, Jr. and Representative Don Edwards to the Honorable Dan Rostenkowski (Attached hereto

States' authority to utilize unitary apportionment on a world-wide bases has been enacted. Finally, the question was raised not long ago in the context of the U.S./U.K. Treaty, and no restrictions on the States were included.[57]

Appellant and its *amici* supporters fall back on international law. They assert that States must forego the use of the unitary apportionment method in favor of the arm's length method which they claim is the uniform international standard. First, no treaty requires that a treaty signatory utilize the arm's length method to calculate the tax of its own domestic corporations, and the *appellant* cites none. Rather, to the extent international treaties deal with the arm's length method, they restrict the use of one nation's taxation methods as they apply to the second nation's domestic corporations.[58] In the instant case, the *appellee* State of California is employing the unitary method to determine the taxable income of an American, not a foreign corporation. Second, there is no international custom that establishes arm's length as the international standard. There is no international definition of "arm's length," there are no agreed upon administrative guidelines, and there is no uniformity of application.

The *appellant* and others speculate that the failure to speak with one voice could result in disputes and retaliation. However, foreign direct investment in the United

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as Addendum I); and September 10, 1982 letter from U.S. Secretary of Labor Raymond J. Donovan to Governor Richard Snelling (Attached hereto as Addendum J).

[57] See footnote 50 *supra*. No provision to limit the States' use of unitary has been included in a tax treaty since then.

[58] "Virtually every U.S. tax treaty contains a saving clause in which the United States reserves the right to tax its citizens without regard to treaty." *Income Tax Treaties* (J. Bischel ed. 1978) at p. 718.

States is up 58% in the last year alone.[59] No retaliation has occurred. And to the extent that foreign governments have addressed the State Department, their letters have concerned the application of the unitary apportionment method to U.S. subsidiaries of foreign companies not foreign subsidiaries of United States corporations, the case at issue.

The interest of foreign countries is focused upon their domestic corporations. In the case at issue California is taxing an United States corporation established in Delaware and headquartered in Illinois. The tax is not on any of the foreign subsidiaries, their minority shareholders or the governments of the nations in which they are doing business. As a result of California's tax there is no decrease in the foreign subsidiaries' equity or assets. Thus, there is no local impact from the perspective of the foreign governments.

If a change is to be made to our present foreign policy that permits the States to apply the unitary method to multinationals, it should be accomplished by Congress and the Administration to which the Constitution has given the responsibility for establishing foreign policy. Congress can weigh all the interests and arguments, evaluate the impact on different corporations and in a variety of circumstances, and choose an appropriate solution after a long deliberative process. This Court is limited to resolving some very complicated tax questions based only on the facts of the case before it.

This Court should not limit the fundamental right of the States to tax merely on the nebulous concept that the unitary apportionment method in some way prevents the federal government from speaking with one voice.

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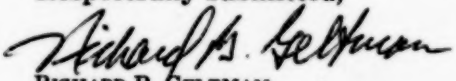
[59] Belli, R. David, "U.S. Business Enterprises Acquired or Established By Foreign Direct Investors in 1981," Survey of Current Business, Bureau of Economic Analysis, United States Department of Commerce (June 1982), p. 27.

CONCLUSION

If this Court finds that the *appellant* was conducting a unitary business enterprise, then your *amici* respectfully urge you to affirm the decision of the California Court of Appeal that the application of the unitary apportionment method to the *appellant* by the *appellee* Franchise Tax Board does not violate either the Due Process or Commerce Clause.

Dated at Washington, D.C. this 14th day of October, 1982.

Respectfully submitted,



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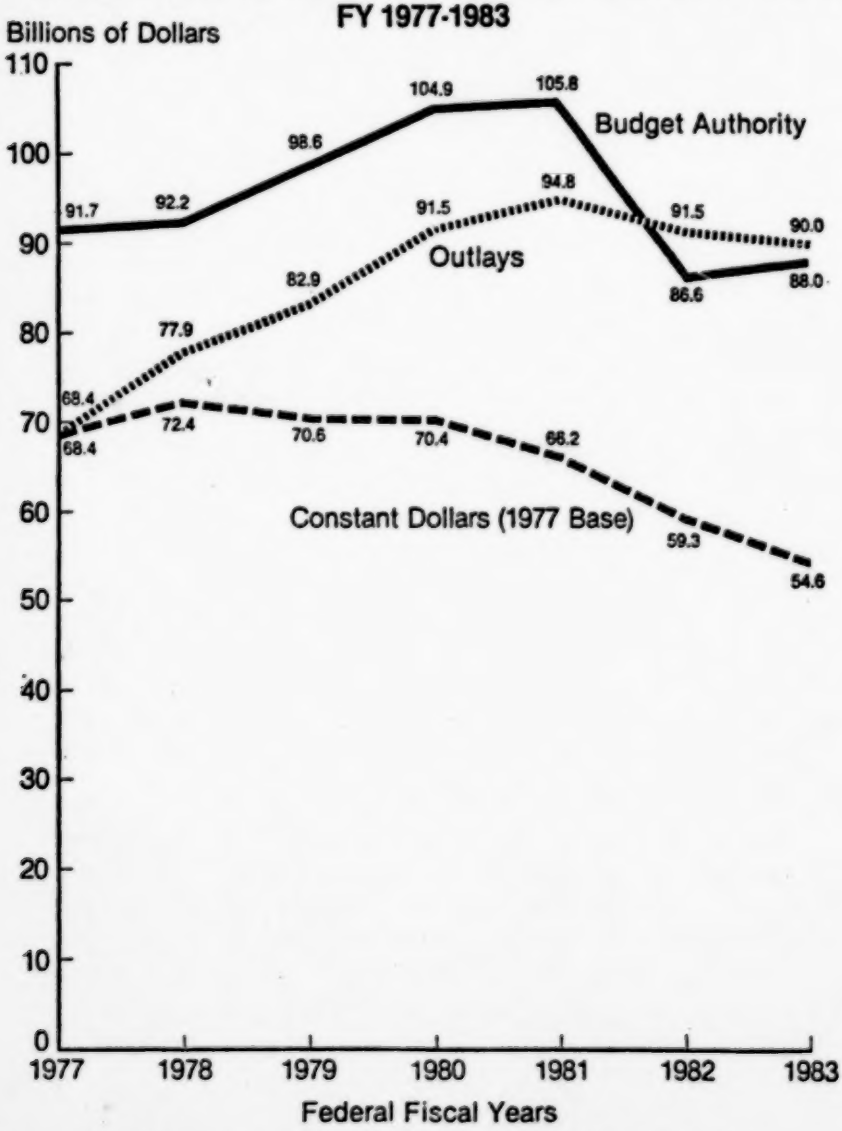
ADDENDUM A

FY 1983 First Budget Resolution

Federal Aid to State and Local Governments

FY 1977-1983



Source: National Governors' Association. Computation based on OMB Special Analysis H and CBO Estimates.

ADDENDUM B

NATIONAL GOVERNORS' ASSOCIATON

February 25, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Several Governors have expressed concern about a position taken by the Department of Justice against state revenue systems which incorporate the unitary tax method. In view of the serious nature of their concern, I am writing, as chairman of the committee of the National Governors' Association with jurisdiction over the issue, to ask for a review of the Department's action.

Chicago Bridge & Iron Company vs. Caterpillar Tractor Co., et al (Docket Number 81-349) is currently before the Supreme Court of the United States on appeal from the Illinois Supreme Court, which upheld Caterpillar's right to report its income for state tax purposes on a unitary accounting basis. The Department of Justice has recently filed an *amicus curiae* brief in this case against the states' ability to tax on a unitary basis. We believe that the Department's intervention is unnecessary and constitutes a serious federal infringement of the power of the states to tax as they choose.

For some time, the Governors have been concerned about federal restrictions on traditional state functions. In August 1980, the National Governors' Association adopted policy stating that "the principle of avoiding preemption by the federal government in areas of primary state responsibility is applicable across the board. . ." Clearly state taxation of our own citizens is such an area. Last fall, the Western Governors' Policy Office

urged your Administration to oppose legislative restrictions on the unitary method (S. 655/H.R. 1983), pointing out that they "would be inconsistent with efforts to sort out responsibilities and with the New Federalism."

If they prevail, the Department of Justice's position in the *Chicago Bridge & Iron* case and the proposed legislative restrictions will cause serious damage to our mutual efforts to restore balance to the federal system and to protect traditional state tax sources. In the short run, the legislation will cost 33 states a minimum of $709 million. In the years to come, all states would lose an important part of their ability to set their own fiscal policies.

We know that you are deeply committed to strengthening the state role in the federal system. We believe that the brief filed by the Department of Justice in this case and the proposed federal legislation are at substantial variance with your commitment. Accordingly, we respectfully request that this brief be withdrawn and that your Administration oppose S. 655 and H.R. 1983. Thank you for your consideration of our concerns.

Sincerely,

/s/ Lamar Alexander
GOVERNOR LAMAR ALEXANDER
Chairman, Committee on Executive
Management and Fiscal Affairs

ADDENDUM C

NATIONAL GOVERNORS' ASSOCIATON

August 3, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

It is our understanding that the Cabinet Council on Economic Affairs will be meeting on Thursday, August 5 to discuss the Administration's position on state utilizaiton of the "unitary apportionment method" of taxation of multinational corporations. Governor Lamar Alexander, on behalf of the National Governors' Association, wrote to you on February 25, 1982 on this matter. At that time he requested that you join the National Governors' Association in opposing two pending Congressional bills, S. 655 and H.R. 1983, that would restrict states' ability to tax multinational corporations and that you have the Department of Justice withdraw the *amicus curiae* brief it filed in the case of *Chicago Bridge and Iron Company* v. *Caterpillar Tractor Company, et al.*, still pending before the Supreme Court of the United States.

I would like to reiterate the concerns expressed in Governor Alexander's letter. At a time when the states are being asked to assume significantly expanded responsibilities under New Federalism, we need access to appropriate revenue sources.

In our opinion the Constitutional question concerning the use of the "unitary apportionment method" of state taxation of multinational corporations and the taxation of intracorporate dividends is more a question of federalism than foreign commerce. Certainly one power reserved

to the states under the Tenth Amendment is the power to design a fair tax system. Absolutely integral to the functioning of a state government is its ability to raise revenues and provide incentives for economic development.

In utilizing the "unitary apportionment method", twenty-two states include domestic subsidiaries in their definition of a unitary business, and twelve states include foreign subsidiaries in that definition. These latter referenced twelve states have estimated that a prohibition on the inclusion of foreign subsidiaries would result in a loss of state revenues of not less than $600 million. For the thirty-eight states which do not include foreign-based subsidiaries in their definition of the taxable corporation, the omission has been used as a state inducement for economic investment and development by foreign corporations. It is the position of the National Governors' Association that states should continue to have the choice to include foreign subsidiaries within their definition of unitary corporation in utilization of the "unitary method of apportionment" on a world-wide basis.

When the National Governors' Association meets in Oklahoma next week, it will be considering a revision to an extant policy position in order to address more directly the question of federal preemption of state revenue systems. One reason for the proposed policy revision is the controversy over state taxation of multinational corporations. The Committee on Executive Management and Fiscal Affairs chaired by Governor Alexander, with the support of the Committee on Community and Economic Development chaired by Governor Bond, has proposed the following amendment to policy position B.-5 entitled "Avoiding Federal Preemption of State Laws and Policies":

> Integral to the operation of state government is the freedom to structure state revenue systems. It is essential that the federal government not preempt,

either directly or indirectly, sources of state revenues, state tax bases or state taxation methods.

In light of the above discussion, we respectfully ask that you support a position which will permit states to: a) utilize the "unitary method of apportionment" with regard to multinational corporations which have foreign subsidiaries, and b) tax intracorporate dividends of multinational corporations.

Thank you for your attention to this matter.

Sincerely,

/s/ Richard A. Snelling
GOVERNOR RICHARD A. SNELLING

cc: Secretary Donald T. Regan, Chairman pro tempore
Cabinet Council on Economic Affairs

ADDENDUM D

NATIONAL GOVERNORS' ASSOCIATON

September 2, 1982

Mr. Richard S. Willamson
Assistant to the President for
Intergovernmental Affairs
The White House
1600 Pennsylvania Aveune, N.W.
Washington, D.C. 20500

Dear Rich:

We especially appreciate your participation in the joint session of the Committee on Community and Economic Development and the Committee on State-Local Relations at the National Governors' Association and annual meeting.

All the governors value the support we have received from your office, particularly with regard to such tax questions as the preservation of the deductibility of state and local taxes and the tax exemption of interest from municipal bonds, and opposition to increases in the gas tax.

You showed a great sensitivity to our concerns during the meeting. Let us say at the outset on behalf of the National Governors' Association, we accept your offer to begin consultation with the Administration earlier in the federal budgetary process commencing with the FY 1984 budget cycle. In addition, we wish to acknowledge our recognition of three very significant announcements that you made that are important to us and were well received. First, we were pleased that you announced the Administration supported the Senate passed version of the comprehensive tax bill, H.R. 4961, and would oppose any further restrictions on industrial revenue bonds. Second, we

were further gratified that you announced that the Presiednt had decided to oppose the Public Employee Retirement Income Security Act (PERISA) legislation, which state and local officials have opposed as unnecessary, intrusive and contrary to the President's federalism initiative. And finally, you said that the President's Cabinet Council on Economic Affairs had met and decided a) that the Administration was opposed to any amendment to H.R. 4961 which would prohibit the states' use of the "unitary apportionment method" of taxing multinational corporations with foreign subsidiaries, and b) that the Administration would take no position at this time on H.R. 1983 and S. 655, which deal with the "unitary" multinational corporations.

Thank you again for participating in our joint session and articulately setting out the Administration's views on federalism, budget, and tax matters.

Sincerely,

/s/ Dick Riley
GOVERNOR RICHARD W. RILEY
Chairman, Committee on
State-Local Relations

/s/ Christopher S. Bond
GOVERNOR CHRISTOPHER S. BOND
Chairman, Committee on
Community and Economic Development

cc: All Governors

ADDENDUM E

NATIONAL GOVERNORS' ASSOCIATON

July 15, 1982

The Honorable Richard A. Snelling
Chairman
National Governors' Association
444 North Capitol Street
Washington, D.C. 20001

Dear Mr. Chairman:

I am writing to you in my capacity as chairman of the Legal Affairs Committee of the National Governors' Association to report the conclusion and recommendation of the Committee in the case of *Container Corporation of America v. Franchise Tax Board*, a case in which the Supreme Court of the United States has noted probable jurisdiction, Docket Number 81-523. The Committee has reviewed relevant documents concerning the above-styled case as well as material concerning the case of *Chicago Bridge and Iron Co. v. Caterpillar Tractor Co.*, a similar case before the Court which has been set for reargument on the Court's next term calendar.

It is our conclusion that *Container Corporation of America* involves important federal constitutional questions relating to whether a state's use of the unitary apportionment method of taxing a domestic corporation with foreign subsidiaries is consistent with the due process and foreign commerce clauses of the United States Constitution. The outcome of the appeal in this case may have a significant effect on federal-state relations, the ability of states to choose their own taxation methods, and the collection of over $600 million in state taxes.

The Legal Affairs Committee recommends that the staff of the National Governors' Association take appropriate

action to file an *amicus curiae* brief on behalf of the *appellee* Franchise Tax Board.

Feel free to call upon me if you have any questions about our recommendations.

Sincerely,

/s/ Allen I. Olson
ALLEN I. OLSON
Governor

cc: Members of the Legal Affairs Committee
Governor Edmund G. Brown, Jr.

ADDENDUM F

NATIONAL GOVERNORS' ASSOCIATON

September 21, 1982

Mr. Larry G. Looney, Commissioner
Taxation & Revenue Department
P.O. Box 26
Boise, Idaho 83722

Mr. Fred Muniz, Secretary
Taxation and Revenue Department
P.O. Box 630
Santa Fe, New Mexico 87509

Dear Commissioner Looney and Secretary Muniz:

The National Governors' Association, representing the elected chief executive officers of the fifty states, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, and the Territories of American Samoa, Guam and the Virgin Islands, is deeply concerned about two recent decisions of the Supreme Court of the United States: *ASARCO, Inc. v. Idaho Tax Commission* and *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico.*

At its most recent annual meeting held in August of this year in Afton, Oklahoma, the Association promulgated an amendment to its policy position entitled "Avoiding Federal Preemption of State Laws and Policies". One of the reasons for this action by the Association was the two aforementioned decisions of the highest federal court and the pending cases of *Chicago Bridge and Iron Company v. Caterpillar Tractor Co. et al.*, Docket Number 81-349, and *Container Corporation of America v. Franchise Tax Board*, Docket Number 81-523, presently before the Court. The amendment reads as follows:

> Integral to the operations of state government is the freedom to structure state revenue systems. It is essential that the federal government not preempt, either directly or indirectly, sources of state revenues, state tax bases or state taxation methods.

The National Governors' Association supports your efforts to obtain rehearings of the *ASARCO* and *Woolworth* cases. In our opinion these two decisions could prevent any state from subjecting interstate business and multistate-multinational business to fair and uniform tax treatment and could result in massive losses of revenues to the states at a time when we are ill equipped to absorb any such losses. Furthermore, these decisions present potentially significant practical difficulties for taxpayers and state tax administrators alike in determining the proper method for filing returns on a yearly basis.

It is our belief that it is essential for the Supreme Court of the United States to grant your petitions for rehearing and reconsider both the impact the decisions will have on federalism and clarify the ambiguities the initial decisions presented.

Sincerely,

/s/ Allen I. Olson
GOVERNOR ALLEN I. OLSON
Chairman, Committee on
Legal Affairs

ADDENDUM G

NATIONAL GOVERNORS' ASSOCIATON

July 19, 1982

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
1102 Cannon House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Integral to our federal system and the operation of state government is the freedom to structure state revenue systems. The Governors seek your strong support for this principle of federalism. As the Ways and Means Committee begins markup of the 1982 tax bill we urge the Committee not to preempt, either directly or indirectly, sources of state revenues, state tax bases, or state taxation methods.

In particular, we urge the Committee not to include in the tax bill: 1) minimum tax provisions that adversely impact the municipal bond market; 2) excise tax increases that would preempt future state increases in those taxes; 3) unreasonable restrictions on industrial revenue development bonds; and 4) any restrictions on state taxation of multinational corporations. The last issue is currently pending before the Supreme Court, and hearings have not yet been held in this Congress.

We are partners in a unique system of government that transcends specific measures to reduce the deficit, balance the budget, and raise federal revenues. Federalism will work only if it is based on a mutually acceptable fiscal federalism. We are prepared to consult and cooperate with the Committee on tax matters to insure that

each level of government has the revenue sources to carry out its responsibilities.

Sincerely,

/s/ Richard A. Snelling
GOVERNOR RICHARD A. SNELLING

cc: Members of the Committee

ADDENDUM H

[SEAL]

STATE OF UTAH

OFFICE OF THE GOVERNOR
Salt Lake City
84114

July 20, 1982

The Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
2111 Rayburn Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I understand that a proposal may be offered in the House Ways and Means Committee sometime this week which would restrict the States' taxing authority.

As incoming Chairman of the National Governors' Association I join with Governor Richard Snelling, current Chairman, in expressing my deep concern over any effort to limit taxing methods and policies employed by one or more of the States.

At the November, 1981 meeting of the Western Governors Policy Office (WESTPO) the member Governors reviewed legislation similar to the language we understand may be proposed in Committee. The bi-partisan group of Western Governors unanimously adopted the following position:

> We affirm our support for the states' right, guaranteed under the Constitution to levy taxes to support important public services. . . . We believe that any federal legislation or other effort that would re-

strict, direct, or diminish state taxation policies, methods or laws would be inconsistent with efforts to sort out responsibilities (between the States and the Federal Government) and with the New Federalism. In addition, it would represent a serious abuse of the Doctrine of States' Rights. We oppose new federal restrictions on state taxation.

It is especially vital to maintain traditional and constitutionally derived State taxing authority as State's are called upon to assume additional responsibilities under a federalism initiative.

I appreicate your attention to this matter and urge your Committee to reject amendments which would circumscribe States' taxing authority.

Sincerely,

/s/ Scott M. Matheson
SCOTT M. MATHESON
Governor

ADDENDUM I

CONGRESS OF THE UNITED STATES

COMMITTEE ON THE JUDICIARY

House of Representatives
Washington, D.C. 20515
Telephone: 202-225-3951

July 20, 1982

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

It is our understanding that your committee may be asked during a mark-up session to consider a proposal to limit or deny the States' use of the unitary apportionment accounting method by which they arrive at the tax liability of multinational corporations doing business within their borders.

As you know, questions involving the rights of the States traditionally, as well as under the Standing Rules of the House of Representatives, have been considered to be within the jurisdiction of the Committee on the Judiciary. Indeed, the Judiciary Committee has considered in the past proposals similar to that which we understand will be offered in your mark-up.

It is our view that the specific effort to amend the Internal Revenue Code in regard to the taxing authorities of the States raises serious, grave and far-reaching Constitutional questions. So serious are these questions with regard to this specific issue that we believe it would require that hearings be held to consider the views of the

nation's Governors, Constitutional specialists and corporations and to update hearings held many years ago by the House Committee on the Judiciary.

Of course, we wish to cooperate fully with the Commitee on Ways and Means. Nevertheless, we believe the Constitutional issues raised and the jurisdictional situation to be so serious with regard to this proposal that we want to advise you of our intention to assert our jurisdiction over any effort by the Ways and Means Committee to limit State taxing authority.

Sincerely,

/s/ Peter W. Rodino, Jr.
Chairman
House Committee on the Judiciary

/s/ Don Edwards
DON EDWARDS
Chairman, Subcommittee
on Civil and Constitutional
Rights

ADDENDUM J

U.S. DEPARTMENT OF LABOR

SECRETARY OF LABOR
Washington, D.C.

Sep. 10, 1982

Honorable Richard Snelling
Governor of Vermont
Chairman
National Governors' Association
444 North Capital Street
Washington, D.C. 20001

Dear Governor Snelling:

I recently received a cover copy of your letter to the President concerning state use of the "unitary apportionment method" of taxation of multi-national corporations. I appreciate your letter because this has been a difficult and controversial issue within the Administration in terms of balancing the foreign policy concerns with the tenets of the New Federalism.

As you know, there are bills pending in both the House and the Senate which would outlaw this method of taxation (H.R. 1983 and S.655). However, legislative action may be moot if the method is declared unconstitutional by the Supreme Court in the pending case *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., et al.* We are continuing to study the issue, but due to the possible constitutional basis of a Supreme Court decision, we decided it would be wise to wait for the Court to rule before taking a position on the legislation.

I appreicate your views on the matter and will give them careful consideration.

Sincerely,

/s/ Raymond J. Donovan
RAYMOND J. DONOVAN

JUL 30 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,
v.
FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

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BRIEF OF THE GOVERNMENT OF THE KINGDOM OF THE NETHERLANDS AS AMICUS CURIAE

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July 30, 1982

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TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
INTEREST OF AMICUS CURIAE	1
SUMMARY OF ARGUMENT	3
ARGUMENT	4
I. APPLICATION OF THE COMBINATION AND APPORTIONMENT METHOD PLACES FAR GREATER BURDENS ON A FOREIGN-BASED ENTERPRISE THAN ON A U.S.-BASED ENTERPRISE	6
II. A STATE'S APPLICATION OF THE COMBINATION AND APPORTIONMENT METHOD TO A NETHERLANDS-BASED ENTERPRISE RAISES QUESTIONS UNDER THE NETHERLANDS FCN TREATY THAT ARE NOT PRESENTED BY ITS APPLICATION TO A U.S.-BASED ENTERPRISE	8
CONCLUSION	13

TABLE OF AUTHORITIES

CASES: Page

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TABLE OF AUTHORITIES—Continued

Page

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U.S. Draft Model Income Tax Treaty, [1 Tax Treaties] Fed. Taxes (P-H) ¶ 1022 (June 16, 1981) 11

IN THE

Supreme Court of the United States

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CONTAINER CORPORATION OF AMERICA,
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On Appeal from the Court of Appeal of the State of California for the First Appellate District

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BRIEF OF THE GOVERNMENT OF THE KINGDOM OF THE NETHERLANDS AS AMICUS CURIAE

INTEREST OF AMICUS CURIAE

The Government of the Kingdom of the Netherlands is party to a Treaty of Friendship, Commerce and Navigation with the United States of America (the "Netherlands FCN Treaty")[1] that limits, *inter alia*, the methods of taxation that a state of the United States may apply to nationals and companies of the Netherlands engaged in trade, through subsidiaries or otherwise, within the state. Netherlands enterprises protected by the treaty constitute the largest single source of foreign direct investment

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[1] Treaty of Friendship, Commerce and Navigation, Mar. 27, 1956, United States-Netherlands, 8 U.S.T. 2043, T.I.A.S. No. 3942.

in the United States.[2] The Netherlands Government therefore has an important, substantial and direct interest in state taxation of multinational businesses.

This appeal presents the question whether California, consistently with the Foreign Commerce Clause and the Due Process Clause of the Constitution, may apply its worldwide combination and apportionment method of taxation to the combined income of appellant, a U.S. parent corporation, and its "downstream" subsidiaries organized and operating solely in foreign countries.[3] This appeal does not present the quite different question whether California or other states may apply such a method to the combined income of a U.S. subsidiary corporation, its "upstream" foreign parent company, and the foreign parent's subsidiaries in other countries. The Netherlands Government has filed a brief amicus curiae in one such case in which the State of California is attempting to apply its combination and apportionment method in this latter manner to the combined incomes of one wholly owned and one partly owned U.S. subsidiary, their Netherlands parent, and the parent's more than 900 other affiliate companies worldwide.[4] The Netherlands Government believes that California and other states may seek to apply that method in the future to additional enterprises protected by the Netherlands FCN Treaty.

The combination and apportionment method burdens a foreign parent more than a domestic parent, as demon-

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[2] *See State Taxation of Foreign Source Income: Hearing on H.R. 5076 Before the Comm. on Ways and Means of the House of Representatives*, 96th Cong., 2d Sess. 308-16 (1980) (statement of counsel for Dutch Employers' Federation); Bureau of Economic Analysis, United States Department of Commerce, 61 *Survey of Current Business* 40-51 (Aug. 1981, No. 8).

[3] Jurisdictional Statement at i (U.S. Sept. 14, 1981).

[4] *See Shell Petroleum N.V. v. Graves*, Civil No. C 81 4302 (MHP) (cross-motions for summary judgment and dismissal argued N.D. Cal. June 1, 1982). California is also applying the same method to companies of other trading partners of the United States. *See, e.g., EMI Ltd. v. Bennett*, No. 80-4114 (9th Cir. Feb. 16, 1982) (remanding to district court) (United Kingdom).

strated below, and therefore raises even more difficult issues than those presented on this appeal. Moreover, it violates treaty rights that a Netherlands parent, as distinct from a U.S. domestic parent, enjoys against unreasonable state taxation—rights granted by the United States in exchange for equivalent rights granted by the Netherlands against Netherlands taxation of U.S. parent firms. The Netherlands Government files this brief to inform the Court of these extra burdens and separate treaty issues, which were not addressed by the parties or the courts below, and to urge the Court, in the event that it upholds application of the combination and apportionment method to a U.S. parent company, to reserve judgment on the permissibility of extending that method to parent companies of the Netherlands and other foreign countries.[5]

SUMMARY OF ARGUMENT

Application of the worldwide combination and apportionment method to a foreign-based enterprise is even more burdensome than its application to a U.S.-based enterprise. When applied to a foreign-based enterprise, the method taxes income of the foreign parent that has already been taxed by other nations. Moreover, the method distorts results more severely and imposes much greater burdens of compliance when applied to a foreign-based rather than a U.S.-based enterprise.

When applied to a Netherlands-based enterprise, the worldwide combination and apportionment method vio-

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[5] It may be noted that, according to the U.S. Government, application of the combination and apportionment method to U.S.-based companies with foreign subsidiaries, as well as to foreign-based enterprises, violates the Commerce Clause. *See* Memorandum for the United States as Amicus Curiae at 16-18, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (U.S. Jan. 14, 1982). However, the Netherlands Government limits its discussion in this brief to the special considerations involved where that method is applied to foreign-based enterprises.

lates the Netherlands FCN Treaty. That treaty adopts the internationally accepted principle that a taxing authority may not apply an apportionment formula to the combined income of a domestic subsidiary, its foreign parent, and the parent's affiliate companies abroad. The serious questions of treaty interpretation presented by such taxation deserve full consideration and should not be foreclosed by an unnecessarily broad ruling in this case, which involves only the taxation of a U.S. parent company not entitled to the protections of the Netherlands FCN Treaty.

ARGUMENT

In recent cases involving application of state "unitary" tax methods to enterprises based in the United States, this Court has considered the increasingly imaginative efforts of certain states to widen the net by which income derived in foreign countries can be caught and included in the tax base to which a state apportionment formula is applied.[6] This case calls into question the broadest application of the state unitary tax concept considered by the Court thus far: an attempt to include in the taxpayer's apportionment base—and thus subject to tax—the income earned by its foreign subsidiaries, but not

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[6] *See F.W. Woolworth Co. v. Taxation & Revenue Department*, 50 U.S.L.W. 4957 (U.S. June 29, 1982) (striking down inclusion in taxpayer's apportionment base of dividends received from foreign subsidiaries constituting discrete business enterprises from parent and "gross-up" not so received but deemed received by federal government); *ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962 (U.S. June 29, 1982) (invalidating inclusion of interest payments from foreign subsidiaries having no other connection with the state and of capital gains from sale of stock in such subsidiaries); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980) (upholding inclusion of dividends received from foreign subsidiaries whose operations were functionally integrated with those of parent).

repatriated to the U.S. parent in the form of dividends or similar payments.[7]

An even broader effort to apply the unitary method—to catch and tax the income earned abroad by *foreign* parent companies and their non-U.S. subsidiaries—has not yet reached the Court, but, as noted above, is now pending in the district courts.[8]

The latter application merits separate consideration because it conflicts directly with the internationally accepted principle, recognized by the U.S. Government in numerous treaties, that a taxing authority must calculate the income of a domestic subsidiary on a basis separate from its foreign parent, adjusting the accounts of the subsidiary only if necessary to reflect transactions between the two that were on other than "arm's length" terms. Under this international consensus, a taxing authority must not combine the income of the subsidiary with the parent's income or treat it as part of a single, "unitary" business, whether or not the subsidiary may be considered functionally integrated with the parent. A state's failure to comply with this principle violates reciprocal rights that the U.S. Government has extended to companies of its trading partners, under treaties ratified with the advice and consent of the Senate, in return for comparable protections of American enterprises abroad. A state's contrary conduct "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,"[9] because it impairs the ability

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[7] The same question is presented on a less fully developed record in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349. In *F.W. Woolworth* the Court held that "gross-up" not received by the taxpayer was not includible in its apportionment base.

[8] *See* note 4 *supra*.

[9] *Cf. Edgar v. Mite Corp.*, 50 U.S.L.W. 4767, 4768 (U.S. June 23, 1982) (plurality opinion) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

of the U.S. Government to guarantee full reciprocity for the protections extended to American companies and fully honored by its treaty partners.

I. APPLICATION OF THE COMBINATION AND APPORTIONMENT METHOD PLACES FAR GREATER BURDENS ON A FOREIGN-BASED ENTERPRISE THAN ON A U.S.-BASED ENTERPRISE

Application of the combination and apportionment method to the worldwide income of a foreign-based enterprise having a U.S. subsidiary is more burdensome than application of such a method to a U.S.-based parent company such as appellant in at least three respects. First, unlike an American parent, a U.S. subsidiary of a foreign parent company has not even an indirect right to the foreign income included in its apportionment base and taxed by the state. When a state includes in the apportionment base of a U.S. subsidiary the income earned from wholly foreign sources by its "upstream" foreign parent and the parent's other subsidiaries, it taxes income that the U.S. subsidiary never receives and has no power to repatriate. In effect, the state is "reaching out" to tax income of the foreign parent that has already been taxed in other jurisdictions and "to which [the state] contribute[s] nothing." [10]

Second, combination and apportionment in a foreign-parent situation leads to a greater distortion in results. The three-factor formula used by the State of California is based on the assumption that the in-state payroll, property, and sales of a "unitary" enterprise produce the same yield as its payroll, property, and sales in all economies throughout the world, an assumption that is demonstrably false.[11] Application of that formula in *any* trans-

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[10] *See F.W. Woolworth Co. v. Taxation & Revenue Department*, 50 U.S.L.W. 4957, 4961-62 (U.S. June 29, 1982).

[11] *Cf., e.g., ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962, 4971 (U.S. June 29, 1982) (O'Connor, J., dissenting) ("economic conditions in Australia and Mexico do not track those in the United States").

national situation inevitably leads to results "less true" than those that would be derived from the use of the internationally accepted arm's length principle.[12] But because a foreign-based firm is likely to carry on a greater percentage of its total operations in economies outside the United States than an American-based firm,[13] applying such a formula to the foreign-based enterprise will produce even greater distortions than applying it to an American-based enterprise.

Third, compliance with state reporting requirements is far more onerous for a foreign-based enterprise. An American parent, by virtue of its U.S. domicile, keeps its books of account in U.S. dollars and in accordance with American accounting principles. To comply with a state's unitary reporting requirements, that parent must convert the accounts of its foreign subsidiaries to U.S. dollars only once, a procedure it would follow in any event if it prepares consolidated financial statements. However, a foreign parent with subsidiaries in third countries must make multiple sets of adjustments and conversions: it must first convert the accounts of its foreign subsidiaries to comply with the tax laws of its country of domicile, and then reformulate those as well as its own accounts to translate them into U.S. dollars and comply with the accounting principles of the state employing the combination and apportionment method. The complications induced by the need to adjust for differences in national accounting practices and fluctuations in currency exchange rates are thus multiplied in the case of a foreign parent. To the extent that different states require different accounting methods, the foreign parent

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[12] *See* Deperon, *International Double Taxation* 25 (1945).

[13] For example, in *Shell Petroleum N.V. v. Graves*, Civil No. C 81 4302 (MHP) (argument N.D. Cal. June 1, 1982), the Netherlands parent company, aside from its two U.S. subsidiaries, had over 900 other subsidiaries operating in over 100 other countries. Complaint ¶ 7.

may be forced to repeat the reformulation and conversion process numerous times. In addition, compliance with the information demands asserted by a taxing state requires the foreign parent to gather and supply volumes of information regarding transactions having no nexus at all with the domestic subsidiary's activities within the state.[14] Compliance becomes especially burdensome when the state retroactively requires information and reconstruction of accounts for tax periods that expired several years before the commencement of the audit. At best the information is stale; at worst, it may be unavailable because the nation of domicile may no longer require the retention of records at the time the state's audit begins.

These three increased burdens—of extraterritorial double taxation, distortion and compliance—raise serious constitutional questions beyond those presented in this case. When imposed on a Netherlands-based enterprise, these burdens also infringe the protections of the Netherlands FCN Treaty.

II. A STATE'S APPLICATION OF THE COMBINATION AND APPORTIONMENT METHOD TO A NETHERLANDS-BASED ENTERPRISE RAISES QUESTIONS UNDER THE NETHERLANDS FCN TREATY THAT ARE NOT PRESENTED BY ITS APPLICATION TO A U.S.-BASED ENTERPRISE

As this Court noted last Term, the Netherlands FCN Treaty is "one of a series of similar commercial agreements negotiated after World War II." [15] Article XI(4)

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[14] For example, in *Shell Petroleum N.V. v. Graves*, Civil No. C 81 4302 (MHP) (N.D. Cal.), the State of California demanded from Shell Oil Company a listing of every crude oil transaction between any of the more than 900 worldwide subsidiaries of the Netherlands parent company. *See* Complaint ¶¶ 23, 25 (N.D. Cal. Nov. 4, 1981); Kennedy Aff., Ex. 1 (N.D. Cal. Feb. 25, 1982).

[15] *Sumitomo Shoji America, Inc. v. Avagliano*, 50 U.S.L.W. 4643, 4646 & n.13 (U.S. June 15, 1982).

of that treaty, which has counterparts in other U.S. FCN treaties,[16] provides in pertinent part:

> "In the case of companies . . . of either Party engaged in trade or other gainful pursuit within the territories of the other Party, such other Party shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to its territories . . . ."[17]

As its wording suggests, this provision was intended to protect American enterprises against excessive taxation within the Netherlands, in exchange for comparable protection of Netherlands enterprises against unreasonable taxation by the United States or its political subdivisions.[18] While this treaty provision does not affect a state's power to tax U.S.-based multinationals such as ap-

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[16] *See, e.g.*, Treaty of Friendship, Commerce and Navigation, Apr. 2, 1953, United States-Japan, art. XI(4), 4 U.S.T. 2063, 2072, T.I.A.S. No. 2863; Treaty of Friendship and Commerce, Nov. 12, 1959, United States-Pakistan, art. XI(4), 12 U.S.T. 110, 116, T.I.A.S. No. 4683. The Netherlands Government recognizes that these treaties, "although similarly worded, may have different negotiating histories," *Sumitomo Shoji America, Inc. v. Avagliano*, 50 U.S.L.W. 4643, 4646 n.12 (U.S. June 15, 1982), and therefore, except where indicated, expresses no view on the interpretation of treaties other than the Netherlands FCN Treaty.

[17] 8 U.S.T. at 2061.

[18] Two additional provisions of the treaty govern more generally the treatment of Netherlands enterprises by governmental authorities within the United States, and thus affect their taxing power. Article I(1) requires that such authorities "at all times accord fair and equitable treatment to the nationals and companies of the [Netherlands], and to their property, enterprises and other interests." Article VI(3) forbids such authorities to impose "unreasonable or discriminatory measures that would impair the rights or interests [within the United States] of nationals and companies of the [Netherlands], whether in their capital, or in their enterprises and the property thereof." 8 U.S.T. at 2045, 2051.

pellant, which are protected against such taxation by the Constitution, it does constrain the states in taxing Netherlands-based enterprises and is therefore implicated by the application of the combination and apportionment method to such enterprises.[19]

The Netherlands Government contends that the Netherlands FCN Treaty forbids a state to tax a U.S. subsidiary of a Netherlands parent under a formula that includes in the subsidiary's apportionment base the "upstream" income of the parent and the parent's other affiliates around the world that is never received, directly or indirectly, by the subsidiary.[20] Such "upstream" combination and apportionment is contrary to the treaty for three reasons. First, the treaty was negotiated against the background of the internationally accepted principle that a domestic subsidiary is to be treated as an independent enterprise from its foreign parent, and that its income is to be determined on the basis of its separate accounts as adjusted to account for any transactions with the parent not made on arm's length terms. This principle has been endorsed in the model double taxation conventions of in-

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[19] U.S. commercial treaties in general, *see, e.g., Nielsen v. Johnson*, 279 U.S. 47 (1929), and the tax articles of modern FCN treaties in particular, *see Deutsche Lufthansa AG v. City of New York*, 85 Misc. 2d 719, 379 N.Y.S.2d 635 (N.Y. Sup. Ct. 1976), *aff'd*, 57 A.D.2d 533, 393 N.Y.S.2d 683 (N.Y. App. Div. 1977) (West German FCN Treaty), limit the taxing power of subnational as well as national governments.

[20] The Netherlands Government does not contend that the treaty forbids a state to include in the U.S. subsidiary's apportionment base the incomes of that subsidiary's own "downstream" subsidiaries outside the United States. The treaty does not address the tax treatment of a U.S. corporation with respect to its foreign subsidiaries. Such "downstream" application of the combination and apportionment method does not implicate the treaty, although, as noted above, the U.S. Government argues that it violates the Commerce Clause of the U.S. Constitution. *See* note 5 *supra*.

ternational organizations from 1928 to the present [21] and embodied in the double taxation treaties of most nations, including the United States.[22] Second, during the negotiation of the FCN Treaty, the Netherlands negotiators were informed by the American representatives that Article XI was consistent with the existing tax treaty between the two countries, which had specifically adopted this principle.[23]

Third, by virtue of the unconditional most-favored-nation treatment guaranteed by Article XI(3) of the Netherlands FCN Treaty,[24] Netherlands companies may

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[21] *See, e.g.*, United Nations, *Model Double Taxation Convention Between Developed and Developing Countries*, arts. 7(2), 9(1), U.N. Doc. ST/ESA/102 (1980); Report of the OECD Comm. on Fiscal Affairs, *Model Double Taxation Convention on Income and on Capital*, arts. 5(7), 7(1), 7(2), 9(1) (1977); Report of the OECD Comm. on Fiscal Affairs, *Draft Double Taxation Convention on Income and Capital*, arts. 5(6), 7(1), 7(2), 9, OECD Doc. C(63)87 (1963); League of Nations Fiscal Comm., *London and Mexico Model Tax Conventions*, League of Nations Doc. C.88.M.88.1946.II.A. (1946).

[22] *See* Memorandum for the United States as Amicus Curiae at 2, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (U.S. Jan. 14, 1982); U.S. Draft Model Income Tax Treaty, arts. 7, 9, [1 Tax Treaties] Fed. Taxes (P-H) ¶ 1022 (June 16, 1981). U.S. double taxation treaties apply to federal taxation only, except for their national treatment clauses. The FCN treaties apply in all respects to state as well as federal taxation. *See* note 19 *supra*.

[23] *See* Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, arts. III-IV, 62 Stat. 1757, 1759-60, T.I.A.S. No. 1855. This principle was carried forward when the Convention was amended in 1965. *See* Supplementary Convention, Dec. 30, 1965, United States-Netherlands, arts. II-III, 17 U.S.T. 896, 899-900, T.I.A.S. No. 6051.

[24] Article XI(3) provides:

> "Nationals and companies of either Party shall in no case be subject, within the territories of the other Party, to the payment of taxes, fees or charges imposed upon or applied to in-

invoke the rights extended to companies of other countries by other U.S. commercial treaties. Article IX(4) of one such treaty, the Convention of Establishment between the United States of America and France,[25] expressly bars imposition of tax by reason of income derived from sources outside the taxing jurisdiction: "[French companies] shall not be subject, within the territories of the [United States], to any form of taxation upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are there engaged, the transactions which they accomplish there, or any other bases of taxation directly related to their activities within those territories." [26]

The U.S. Government has recognized that application of the unitary method "may violate" the French Convention and "certain" other FCN treaties.[27] The Netherlands Government contends that the application of that method to a Netherlands-based enterprise violates the Netherlands FCN Treaty. In any event, the serious questions of treaty interpretation presented by such taxation deserve full consideration, and should not be foreclosed by the Court's decision on this appeal.

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come, capital, transactions, activities or any other object, or to requirements with respect to the levy and collection thereof, more burdensome than those borne by nationals, residents and companies of any third country." 8 U.S.T. at 2060-61.

[25] Signed at Paris, Nov. 25, 1959, 11 U.S.T. 2398, T.I.A.S. No. 4625.

[26] *Id.* at 2409-10.

[27] Memorandum for the United States as Amicus Curiae at 16-17, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (U.S. Jan. 14, 1982).

CONCLUSION

Application of the combination and apportionment method of taxation to a foreign-based enterprise is more burdensome than its application to a U.S.-based enterprise. If the Court invalidates the inclusion of the income of appellant's foreign subsidiaries in its apportionment base, *a fortiori* the inclusion of a foreign parent's income in the apportionment base of its U.S. subsidiary would be forbidden. On the other hand, if the Court should uphold the tax treatment of appellant, it should reserve judgment on the serious constitutional issues that would nonetheless be posed by "upstream" combination reaching the income of a foreign parent.

In addition, "upstream" combination of the incomes of a U.S. subsidiary and a Netherlands parent raises serious questions of violation of the Netherlands FCN Treaty. The Netherlands Government urges the Court to confine any ruling in this case in a manner that will avoid unnecessarily prejudicing the consideration of those treaty issues in a subsequent case in which they are directly presented.

Respectfully submitted,

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,
v.
FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF THE STATE OF NEW MEXICO AS AMICUS CURIAE IN SUPPORT OF THE FRANCHISE TAX BOARD

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QUESTIONS PRESENTED

1. Whether standards exist for the determination whether foreign commerce is an issue in this case.

2. Whether foreign commerce is necessarily burdened by the imposition of a fairly apportioned tax on the income of a multinational unitary business.

3. Whether multiple burdens of taxation alone are proscribed by the commerce clause.

4. Whether a broad national policy pre-emption standard is warranted in determining the validity of a state income tax and whether, under such a broad standard, California's franchise tax is invalid.

TABLE OF CONTENTS

(Page(s)

TABLE OF AUTHORITIES iii

INTEREST OF THE STATE OF NEW MEXICO 1

SUMMARY OF ARGUMENT 2

ARGUMENT 3

I. NO STANDARDS EXIST FOR THE DETERMINATION WHETHER FOREIGN COMMERCE IS AN ISSUE IN THIS CASE 3

II. THE IMPOSITION OF A FAIRLY APPORTIONED TAX ON THE INCOME OF A MULTINATIONAL UNITARY BUSINESS DOES NOT BURDEN FOREIGN COMMERCE 7

III. SHOULD THE COURT FIND THAT THIS CASE PRESENTS A FOREIGN COMMERCE QUESTION, *JAPAN LINE* SHOULD NOT BE FOLLOWED 9

A. Multiple Burdens Alone Are Not Proscribed By The Commerce Clause 10

B. *Japan Line's* National Policy Pre-emption Standard Is Overly Broad; Even Under That Standard, However, California's Tax Is Not Pre-empted 15

TABLE OF AUTHORITIES

CASES: Page (s)

Alaska v. Arctic Maid,
366 U.S. 199 (1961) 5

Alessi v. Raybestos – Manhattan, Inc.,
451 U.S. 504 (1981) 18

Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,
266 U.S. 271 (1924) ..... 2, *passim*

Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977) 12

Butler Bros. v. McColgan,
315 U.S. 501 (1942) 8

Central Greyhound Lines, Inc. v. Mealey,
334 U.S. 653 (1948) 8, 13

Central R.R. Co. v. Pennsylvania,
370 U.S. 607 (1962) 11

Chicago & North Western Transportation Co. v. Kalo Brick & Tile Co., 450 U.S. 311 (1981) 16, 17

City of Philadelphia v. New Jersey,
437 U.S. 617 (1978) 17

Complete Auto Transit, Inc. v. Brady,
430 U.S. 274 (1977) 5, 9, 14, 15

Commonwealth Edison Co. v. Montana,
453 U.S. 609 (1981) ..... 5, *passim*

Davidson v. New Orleans,
96 U.S. 97 (1878) 14

Department of Revenue v. Washington Stevedoring Cos., 435 U.S. 734 (1978) 13

Dunbar-Stanley Studios, Inc. v. Alabama,
393 U.S. 537 (1969) 5

East Ohio Gas Co. v. Tax Commission,
283 U.S. 465 (1931) 6

Page(s)

Evco v. Jones,
409 U.S. 91 (1972) 11

Exxon Corp. v. Governor of Maryland,
437 U.S. 117 (1978) 19, 20

Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980) 12

Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963) 17

Frick v. Pennsylvania,
268 U.S. 473 (1925) 14

Gibbons v. Ogden,
22 U.S. (9 Wheat.) 1 (1824) 14, 21

Hines v. Davidowitz,
312 U.S. 52 (1941) 17

J. D. Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938) 11, 12

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) ..... 3, *passim*

Jones v. Rath Packing Co.,
430 U.S. 519 (1977) 17

Lane County v. Oregon,
74 U.S. (7 Wall.) 71 (1868) 21

McCullock v. Maryland,
17 U.S. (4 Wheat.) 316 (1819) 21

Michelin Tire Corp. v. Wages,
423 U.S. 276 (1976) 15, 16, 18

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) ..... 6, *passim*

Moorman Manufacturing Co. v. Bair,
437 U.S. 267 (1978) 12, 13, 14, 21

New Motor Vehicle Board of California v. Orrin W. Fox Co., 439 U.S. 96 (1978) 19

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Page(s)

Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) 5

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Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169 (1949) 11

Perez v. Campbell, 402 U.S. 637 (1971) 17

Spector Motor Service v. O'Connor, 340 U.S. 602 (1951) 5

Standard Oil Co. v. Peck, 342 U.S. 382 (1952) 11

Standard Pressed Steel Co. v. Washington Department of Revenue, 419 U.S. 560 (1975) 12

State Tax Commission v. Interstate Natural Gas Co., 284 U.S. 41 (1931) 6

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) 8

Ward v. Maryland, 79 U.S. (12 Wall.) 418 (1870) 21

Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938) 5, 11, 12

CONSTITUTION OF THE UNITED STATES

Commerce Clause ..... 2, *passim*

Due Process Clause 2

Import-Export Clause 15, 16

TREATISES AND LAW REVIEWS Page(s)

JEROME R. HELLERSTEIN AND WALTER HELLERSTEIN, STATE AND LOCAL TAXATION (4th ed. 1978) 12

Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H. R. 5076*, 79 MICH.L.REV. 113 (1980) 20

Note, *Constitutional Law – The Scope of the Commerce Clause in International Commerce*, 55 WASH.L.REV. 885 (1979) 10

LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW (1978) 12

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On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF THE STATE OF NEW MEXICO AS AMICUS CURIAE IN SUPPORT OF THE FRANCHISE TAX BOARD

INTEREST OF THE STATE OF NEW MEXICO

Container Corporation of America challenges California's franchise tax, imposed under an apportionment formula which is applied to Container's worldwide operations, on due process and commerce clause grounds. Container argues that California's tax misapportions income to domestic members of its

operations, thus overreaching, in violation of the due process clause. Additionally, Container argues that California's tax results in multiple burdens of taxation, and that California's use of the apportionment method on its worldwide income conflicts with the federal system of arms-length reporting, thus preventing the federal government from speaking with one voice in matters of foreign commerce. On these grounds Container argues that the tax violates the commerce clause. Container also argues that it does not conduct a unitary business with its foreign subsidiaries.

New Mexico employs the unitary apportionment method of determining the income of multijurisdictional corporations. It is vitally interested in the Court's resolution of the issues presented in this case. This brief is therefore submitted in support of the Franchise Tax Board and the validity of California's tax.

SUMMARY OF ARGUMENT

Container seeks to show that it does not conduct a unitary business with its foreign subsidiaries. Although Container raises this point at the end of its brief, the unitary question must be addressed before California's tax may be analyzed under the due process and commerce clauses. This brief assumes a unitary operation and a tax valid on due process grounds as a basis for its discussion of the commerce clause issues raised by Container.

Container argues that California's franchise tax, imposed on its worldwide operations, violates the commerce clause because it burdens foreign commerce. However, Container has not shown that foreign commerce is an issue in this case. Applying *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924) and the accepted bases of the apportionment method of determining income to the facts of this case, the Court must find that foreign commerce is not burdened by the

imposition of a fairly apportioned tax on a multinational unitary business.

Container asks the Court to invalidate California's tax under the two-part foreign commerce test established in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). *Japan Line* is not applicable to this case because, under the holding of *Bass, Ratcliff*, foreign commerce is not an issue. However, even should the Court find that foreign commerce is an issue here, *Japan Line* should not be followed. *Japan Line* imposed a proscription against multiple burdens of taxation when foreign commerce is involved. However, multiple burdens of taxation alone are not proscribed by the commerce clause. *Japan Line* held that a state tax will be held invalid when it interferes with the achievement of federal uniformity in the field of foreign relations. The Court thus pre-empted a state tax on the basis of general national policy. The national policy standard has been rejected in pre-emption analysis. Additionally, even under a broad pre-emption standard, Container cannot prevail in its argument, because it has not shown the existence of a national policy which governs state taxation of the income of multijurisdictional corporations.

ARGUMENT

I

NO STANDARDS EXIST FOR THE DETERMINATION WHETHER FOREIGN COMMERCE IS AN ISSUE IN THIS CASE.

Container argues that imposition of California's franchise tax on an apportioned part of the combined income realized from its worldwide operations burdens foreign commerce and violates the commerce clause of the Constitution. (Brief of Appellant at 21) Container urges the Court to apply *Japan Line,*

Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) and invalidate California's tax under the two-part test announced in that case.[1]

It is necessary to the invocation of *Japan Line* that foreign commerce be an issue in this case. Container contends that it is. The basis of Container's contention is unclear, however. Container's foreign commerce argument contains two threads: 1) that California's apportionment formula overreaches, misattributes income and thus taxes foreign profits (Brief of Appellant at 11, 21); and 2) that because multinational corporations may be subject to multiple tax burdens and because there is a need for federal uniformity in the area of foreign commerce, the taxation of multinational corporations necessarily implies a foreign commerce question. (Brief of Appellant at 21-39) Container has tangled the threads of its argument and invites the Court to invalidate combined reporting as applied to multinational businesses on foreign commerce grounds alone. (Brief of Appellant at 37)

Logically, however, Container's argument must be analyzed in two stages. First, it must be determined whether California's apportionment formula, as applied to Container's worldwide business, overreaches. If the Court finds that it does, the tax is invalid under the due process clause and there is no need to reach the foreign commerce question. If it does not, the Court must then address the question whether taxation of a multinational corporation under an acceptable apportionment formula necessarily involves foreign commerce. Crucial to the second determination is a knowledge of what constitutes foreign commerce for tax purposes. Although Container and its *amici* make facile use of the term "foreign commerce," there is no indication that the term has a commonly accepted meaning.

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1 The elements of the test are 1) whether the tax subjects foreign commerce to multiple tax burdens, and 2) whether the tax impairs federal uniformity. *Japan Line*, 441 U.S. at 448.

When analyzing state taxes which are alleged to burden interstate commerce, there is no longer a need to quibble over what does or does not amount to interstate commerce for tax purposes.[2] In this Court's decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288-89 (1977), the rule, enunciated in *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951), that certain aspects of interstate commerce were immune from taxation was flatly rejected. The Court then adopted the far more workable rule that a state could tax activities in interstate commerce as long as its tax met certain criteria. Because *Japan Line* imposed a separate commerce clause test for analyzing taxes which are alleged to burden foreign commerce, the Court immunized foreign commerce from state taxation in certain circumstances. Thus, in the area of foreign commerce, *Japan Line* has brought us back to the same abstract and difficult questions previously presented in interstate commerce analysis. Tax administrators, taxpayers and eventually the courts must once again struggle to define foreign commerce and to devise tests to separate purely foreign commerce from the complicated system of local, interstate and foreign commerce in which modern business operates.[3]

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2 *See Commonwealth Edison Co. v. State of Montana*, 453 U.S. 609, 614-15 (1981) and n. 3, *infra*.

3 Since it was thought that the commerce clause prohibited states from directly taxing interstate commerce, it became necessary to distinguish local from interstate commerce. *See, e.g., Dunbar-Stanley Studios, Inc. v. Alabama*, 393 U.S. 537 (1969) (photography is local event, and so taxable, although photographer is out-of-state corporation); *Alaska v. Arctic Maid*, 366 U.S. 199 (1961) (tax on freezer ships is tax on local activity, even though fish are transported out-of-state after freezing); *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951) (when sale can be attributed to local business activities, gross receipts of out-of-state company are taxable); *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938) (tax on sale of advertising space in magazine with interstate circulation is

(Cont. p. 6)

However, the *Japan Line* decision does not provide a definition of foreign commerce which may be applied to the facts of this case. Because of the unique characteristics of the containers taxed in *Japan Line*, the Court addressed the question of whether foreign commerce was involved in one sentence: "Appellants' containers, however, are instrumentalities of foreign commerce, both as a matter of fact and as a matter of law." 441 U.S. at 445-46 (footnotes omitted). Perhaps it is easier to identify "instrumentalities of foreign commerce," *id.*, than to determine generally what foreign commerce may be for tax purposes. It is clear, however, that the issue of whether taxation of multinational business presents the kind of foreign commerce question the Court addressed in *Japan Line* is a complex one, and one which has not been adequately addressed by Container.

Subsequent to its decision in *Japan Line* that foreign commerce is to be treated differently from interstate commerce, *id.* at 446, the Court has not provided guidance on when that treatment will be afforded. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), the Court declined to apply *Japan Line* to a case involving income taxes, stating that "the

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3. (Cont. from p. 5)
permissible because preparing and printing advertising is local event); *Oliver Iron Mining Co. v. Lord*, 262 U.S. 172 (1923) (mining is a local activity, and so taxable despite fact that ore will be shipped out-of-state). The distinction between local and interstate activities, difficult and sometimes arbitrary, leads to anomalous results. *Compare, e.g., East Ohio Gas Co. v. Tax Commission*, 283 U.S. 465 (1931) (transmission of gas to Ohio municipalities under low pressure is local business and so taxable) with *State Tax Commission v. Interstate Natural Gas Co.*, 284 U.S. 41 (1931) (transmission of gas to distributors in Mississippi part of interstate commerce and so not taxable). This approach was finally found unworkable in the area of interstate commerce. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981). It may prove to be equally unworkable in the area of foreign commerce.

factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." *Id.* at 448. Thus, although the Court in *Mobil* did not offer guidance on what foreign commerce is for state taxation purposes, its opinion indicates that foreign commerce is not burdened by the application of a fairly apportioned tax on unitary income.[4]

II

THE IMPOSITION OF A FAIRLY APPORTIONED TAX ON THE INCOME OF A MULTINATIONAL UNITARY BUSINESS DOES NOT BURDEN FOREIGN COMMERCE.

Although it is unclear what foreign commerce is for tax purposes, the holding of *Bass, Ratcliff & Gretton, Ltd. v.State Tax Commission,* 266 U.S. 271 (1924)[5] indicates that this case does not present a foreign commerce issue. In that case, a foreign corporation contended that the application of New York's franchise tax to an apportioned share of the profits realized by the corporation in conducting its unitary business imposed a burden on foreign commerce and thus violated the commerce clause. The Court found that where a corporation conducts a unitary business both within and without the country, New York could tax a proportionate share of the profits earned by

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4 The *Mobil* Court cited *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n,* 266 U.S. 271 (1924). 445 U.S. at 438.

5 Container seeks to characterize *Bass, Ratcliff* as so outmoded as to be inapplicable. (Brief of Appellant at 8, n. 2) However, this Court in *Mobil,* 445 U.S. at 438, apparently found it was still viable, citing it as the "leading example" of the application of the rationale that "factors of profitability arise from the operation of [a] business as a whole, [thus] it becomes misleading to characterize the income of the business as having a single identifiable 'source,' " 445 U.S. at 438, to "businesses operating both here and abroad." *Id.*

the corporation without offending the commerce clause, as long as the tax was "based upon the portion of such ascertained net income determined by the proportion which the aggregate value of specified classes of the assets of the corporation within the State bears to the aggregate value of all such classes wherever located." *Id.* at 278. The Court's conclusion that New York's tax did not burden foreign commerce was based on the accepted principle that a proper method of apportionment, applied to the combined income of a unitary business, " 'reache[s], and [is] meant to reach, only the profits earned within the [taxing] State.' "[6] *Id.* at 281 (quoting *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920)).

Bass, Ratcliff is directly applicable to this case. Container's attempts to distinguish it (Brief of Appellant at 8, n. 2) are not persuasive. Container first argues that *Bass, Ratcliff* is not controlling because the corporation in that case did not operate through subsidiaries, but rather through operating divisions. This argument ignores the teaching of *Mobil* that the "form of business organization may have nothing to do with the underlying unity or diversity of business enterprise." 445 U.S. at 440. Second, Container argues that the taxpayer in *Bass, Ratcliff* did not allege that New York's apportionment formula misattributed income and hence the case is inapposite. This

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6 In the hysteria produced by the sanctity of foreign profits the fact that a proper apportionment formula will not reach them is overlooked. Yet this Court has stated that a proper formula will "reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to [the taxing state] its just proportion of the profits earned by appellant from this unitary business." *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942). The underlying premise of the apportionment process is that it allows the taxing state to tax only those profits which are attributable to it. *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948).

argument reflects the confusing approach Container takes in this case.[7] Container's allegation of misattribution of income is pertinent to this Court's determination of first, whether Container is a unitary business and second, whether California's apportionment formula adequately determines Container's California income. If the Court answers these two questions in the affirmative, *Bass, Ratcliff* is directly applicable to the next issue before the Court: whether application of an acceptable apportionment formula to a multinational unitary business burdens foreign commerce. *Bass, Ratcliff's* unequivocal answer is that it does not. Therefore, should the Court find that California's apportionment formula meets due process standards, the Court should find that *Bass, Ratcliff* is controlling and foreign commerce is not burdened in this case. To apply *Japan Line* and its foreign commerce test would necessitate overruling *Bass, Ratcliff* and the cases which follow it.

III

SHOULD THE COURT FIND THAT THIS CASE PRESENTS A FOREIGN COMMERCE QUESTION, *JAPAN LINE* SHOULD NOT BE FOLLOWED.

In *Japan Line* the Court held that where foreign commerce was at issue, a challenged tax must meet two tests in addition to those imposed by *Complete Auto Transit.* These tests are 1) whether the tax subjects foreign commerce to multiple tax burdens, and 2) whether the tax prevents the federal government from speaking with one voice in its relations with foreign nations. The multiple burdens test is not compelled by the Constitution. The broad pre-emption standard developed under the federal uniformity test is not warranted under the supremacy clause. Container does not show that California's tax is pre-empted even under the broad standard imposed. For these reasons the *Japan Line* tests should not be applied in this case.

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[7] *See* Part I, *supra.*

A. Multiple Burdens Alone Are Not Proscribed By The Commerce Clause.

The first part of the extended foreign commerce test established in *Japan Line* is that the questioned tax must not subject foreign commerce to multiple burdens of taxation. The Court in *Japan Line* introduced its multiple burden test with the statement that "[i]t is a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause." 441 U.S. at 446. The Court cited the "enhanced risk" of multiple burdens in the area of foreign commerce as the basis for imposition of this test.[8] *Id.* However, multiple burdens of taxation without more are not proscribed by the commerce clause.[9] While the term "multiple burdens" is often used to call into question the constitutionality of state taxing schemes, the doctrine underlying the term is complex

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8 One commentator suggests that the Court's decision to develop a different standard for foreign commerce questions was based on an attempt to apply a doctrine of interstate commerce which prohibits *states* from imposing undue burdens on commerce, to international commerce, an application which cannot logically be made. The Court in *Japan Line* reasoned that because Japan taxed the containers in full, California's tax was prohibited. However, the commentator argues, the only commerce clause inquiry the Court in *Japan Line* need have made was whether California's tax burdened commerce. Japan's imposition of a tax was irrelevant to this inquiry as was the Court's inability to require that Japan's tax be apportioned. Note, *Constitutional Law – The Scope of the Commerce Clause in International Commerce*, 55 WASH.L.REV. 885, 892 (1979); *see Mobil:* "[I]t [Mobil's argument] attempts to focus attention on the effect of foreign taxation when the effect of domestic taxation is the only real issue." 445 U.S. at 447. If the Court's inquiry under the commerce clause is limited to whether a state tax has unduly burdened commerce, a separate foreign commerce test is unnecessary.

9 None of the cases cited by the Court in support of its statement that multiple taxation may offend the commerce clause held that multiple burdens alone are forbidden. Rather multiple burdens which resulted in

(Cont. p. 11)

and embodies two important aspects of commerce clause analysis, *i.e.*, that taxes which impose discriminatory multiple burdens on interstate commerce are forbidden, and that taxes imposed upon interstate commerce must be fairly apportioned.

The origins of the multiple burden test in commerce clause analysis may be found in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). That case announced that multiple taxation, while not in itself unconstitutional, could violate the commerce clause if it resulted in a cumulative tax burden which discriminated against interstate commerce. Other cases have also indicated that multiple taxation is repugnant to the commerce clause only when it causes interstate commerce to bear a greater tax burden than local commerce. *See Evco v. Jones*, 409 U.S. 91, 94 (1972); *Standard Oil Co. v. Peck*, 342 U.S. 382, 384-85 (1952); *Ott v. Mississippi Valley Barge Line Co.*, 336

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9. (Cont. from p. 10)
discrimination against interstate commerce were found invalid under the clause, as were taxes which were not fairly apportioned. *Evco v. Jones*, 409 U.S. 91, 94 (1972) (tax invalidated because it subjected interstate commerce to risks of a double tax burden to which intrastate commerce was not exposed); *Central R.R. Co. v. Pennsylvania*, 370 U.S. 607, 614 (1962) (tax by domiciliary state of *full value* of rolling stock invalid where other states could apply apportioned taxes); *Standard Oil Co. v. Peck*, 342 U.S. 382, 384-85 (1952) (tax invalidated because it imposed multiple burdens on vessels engaged only in interstate commerce); *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169, 174 (1949) (tax valid because "[it] has no cumulative effect caused by the interstate character of the business . . . [and] seems therefore to square with our decisions holding that interstate commerce can be made to pay its way by bearing a nondiscriminatory share of the tax burden which each State may impose on the activities or property within its borders."); *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307, 311 (1938) (tax invalid because it would subject interstate commerce "to the risk of a double tax burden to which intrastate commerce is not exposed.") None of these cases invalidated an apportioned tax imposed by a jurisdiction with an appropriate claim to tax.

U.S. 169, 174 (1949); *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307, 311 (1938). This Court has stated that the fundamental principle to be applied in commerce clause analysis is: "No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce. . . .' [citations omitted]. The prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Clause." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 329 (1977) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

The broadening of the states' power to tax interstate commerce, announced in *Western Live Stock* and the cases which followed it, was accompanied by the requirement that a tax imposed by a state be apportioned by methods which reflected the state's connection with the object of taxation.[10] Because the commerce clause prohibits multiple burdens of taxation which fall only on interstate commerce, and because more than one jurisdiction may have the right to tax interstate commerce, apportionment became essential to validation of a state tax under the commerce clause.[11] Where a tax is fairly apportioned there can be no multiple tax burden. *Japan Line*, 441 U.S. at 447-48; *see Mobil; Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980); *Standard Pressed Steel Co. v. Washington Department of Revenue*, 419 U.S. 560 (1975). In the absence of a showing that a challenged tax is not properly apportioned, a multiple burdens claim may not successfully be made. *See Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

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10 The multiple burdens doctrine is linked with jurisdictional analysis under the commerce clause. *See* LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW §6-17, at 361 (1978).

11 *See* JEROME R. HELLERSTEIN AND WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 243 (4th ed. 1978).

The pertinent question in multiple burden cases is not whether one or more jurisdictions are taxing the same income, property or activity but rather whether the state in question is exacting a fair demand for the aspect of interstate commerce to which it bears a relation. *See Department of Revenue v. Washington Stevedoring Cos.*, 435 U.S. 734 (1978); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948). The fact that two jurisdictions are imposing a tax on the same property or activity is not a sufficient basis for invalidation of a tax on commerce clause grounds.[12] If California's tax is found to be fairly apportioned and treats domestic, interstate and foreign commerce with an even hand, the imposition of a tax by other jurisdictions is not relevant to the validity of California's tax under the commerce clause.

Container's multiple burden theory is flawed in two significant respects. First, had California imposed a gross receipts tax instead of an income tax on Container's California operations the economic effect on Container would have been the same, yet Container would have no basis for complaint under its multiple burdens theory. *See Moorman*, 437 U.S. at 280. Under this theory it is the imposition of an "income" tax by more than one jurisdiction which invalidates the tax. It would be an exercise in formalism to find a tax invalid on the basis

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12 The Court in *Moorman* addressed the question whether Iowa's corporate income tax should be held invalid because, together with Illinois' tax, it allegedly subjected interstate commerce to multiple tax burdens. The Court stated that:

> [W]hatever disparity [in treatment of local and foreign corporations] may have existed is not attributable to the Iowa statute. It treats both local and foreign concerns with an even hand; the alleged disparity can only be the consequence of the combined effect of the Iowa *and* Illinois statutes, and Iowa is not responsible for the latter.

437 U.S. at 277, n. 12.

of speculative concerns with multiple taxation if the same tax, but with a different name, would be valid under the commerce clause.[13] *Id.*

Second, multiple taxation on the total value of property or on income is constitutionally valid when the taxes are imposed by jurisdictions with concurrent rights to tax. Concurrent federal and state taxation of income is a well-established norm. *Mobil*, 445 U.S. at 448. Death taxes on the same estate can be imposed by both the state and federal governments. *Frick v. Pennsylvania*, 268 U.S. 473 (1925). The Constitution does not prohibit taxation of real estate by two concurrent jurisdictions. *See Davidson v. New Orleans*, 96 U.S. 97 (1878). The allowance of multiple taxation by jurisdictions with concurrent rights to tax is based on the fact, long recognized by this Court, that the power to tax is a fundamental attribute of sovereignty. *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 198-99 (1824). In this case California and the federal government have concurrent rights to tax Container's income. Presumably, California also enjoys such a concurrent right with foreign jurisdictions with rights to tax parallel to those of federal government. Yet Container argues that because another jurisdiction also imposes a tax on its income, California's tax must be held invalid. Container's argument is not persuasive in light of the case law cited above.

It is only when a challenged tax discriminates against commerce or is not fairly apportioned that a valid multiple burden claim may be made under the commerce clause. The *Complete*

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[13] It would be an equally formalistic approach to find California's tax invalid merely because another jurisdiction is also imposing an income tax where no facts about the nature or level of that tax are alleged or proved. Yet, in *Japan Line* the fact that Japan imposed a "property" tax was sufficient to call into question the validity of the county's tax. Facts about the actual nature, the level or the incidence of that tax were not required. 441 U.S. at 452, n. 17.

Auto Transit test incorporates these two requirements. 430 U.S. at 277-78. The Court in *Japan Line* held that the county's tax met these two tests, finding that the tax was not discriminatory and was fairly apportioned. 441 U.S. at 445. An additional proscription against multiple burdens alone in the area of foreign commerce is not compelled by the commerce clause. The imposition of the *Japan Line* multiple burdens test will preclude state taxation whenever a foreign jurisdiction imposes, or has the right to impose, a tax.[14] This result contravenes principles of federalism and ignores the states' sovereign right to tax. For these reasons the test should not be imposed in this case.

B. *Japan Line's* National Policy Pre-emption Standard Is Overly Broad; Even Under That Standard, However, California's Tax Is Not Pre-empted.

The second part of the foreign commerce test announced in *Japan Line* requires that a state tax be held invalid under the commerce clause if it prevents the federal government from speaking with one voice in matters of foreign commerce. The *Japan Line* Court cited the principle it established in *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976): " '[T]he Federal Government must speak with one voice when regulating commercial relations with foreign governments,' " 441 U.S. at 449, noting that "[t]he policies animating the Import-Export

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[14] The Court in *Japan Line* adopted an allocation approach and suggested that the mere possibility of multiple taxation will preclude a state tax. 441 U.S. at 446. In effect this approach is remarkably similar to that reached under the home port doctrine under which only the home port was allowed to tax a vessel engaged in interstate commerce. But the Court in *Japan Line* noted that the home port doctrine "has yielded to a rule of fair apportionment," 441 U.S. at 442, and "can claim no unequivocal constitutional source." *Id.* at 443.

Clause [under which *Michelin* was decided] and the Commerce Clause are much the same."[15] *Id.* at 449, n. 14.

Although not so demonimated, the one-voice test is essentially a pre-emption test. Under traditional pre-emption analysis "[p]re-emption of state law by federal statute or regulation is not favored 'in the absence of persuasive reasons – either that the nature of the regulated subject matter permits no other conclusion, or that Congress has unmistakenly so ordained.' " *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 634 (1981) (quoting *Chicago & North Western Transportation Co. v. Kalo Brick & Tile Co.,* 450 U.S. 311, 317 (1981)). Whether

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15 Although the Court cited *Michelin* with approval it did so without adopting the rationale or holding in that case. In *Michelin* an ad valorem tax was imposed on imported tires stored in a warehouse. Michelin claimed that imposition of the tax violated the import-export clause. The Court in *Michelin* found no violation of the clause, emphasizing the nondiscriminatory nature of the tax. The Court stated:

> It is obvious that such nondiscriminatory property taxation can have no impact whatsoever on the Federal Government's exclusive regulation of foreign commerce, probably the most important purpose of the Clause's prohibition. By definition, such a tax does not fall on imports as such because of their place of origin. It cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot be applied selectively to encourage or discourage any importation in a manner inconsistent with federal regulation.

423 U.S. at 286. The reasoning applied under the import-export clause in *Michelin* may be applied to commerce clause questions as well. 441 U.S. at 449, n. 14. The *Japan Line* tax met the requirements of *Michelin:* it was "nondiscriminatory"; it did not fall on instrumentalities of foreign commerce because of "their place of origin"; it could not be used to protect domestic instrumentalities; and it could not "be applied selectively to encourage or discourage" commerce. 423 U.S. at 286. Yet, while the Court found the *Michelin* tax valid, it invalidated the county's tax in *Japan Line.*

a state law has been pre-empted by federal laws or treaties touching the same subject depends upon whether the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). A state law may be found to have been pre-empted either because of an actual conflict between the state and federal statutes or regulations, or by evidence of a congressional design to pre-empt the field. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132 (1963). Deciding whether a state statute is invalid under the supremacy clause because it conflicts with federal law " 'is essentially a two-step process of first ascertaining the construction of the two statutes and then determining the constitutional question whether they are in conflict.' " *Chicago & North Western Transportation Co. v. Kalo Brick & Tile Co.*, 450 U.S. at 317 (quoting *Perez v. Campbell*, 402 U.S. 637, 644 (1971)). This conflict can be found either in provisions contradictory on their face or from a conflict between the state statute and the objectives underlying the federal enactment. *See Jones v. Rath Packing Co.*, 430 U.S. 519 (1977). When no actual conflict exists, state law must yield only when the nature of the subject matter or an explicit declaration of congressional design to displace state law so requires, and federal occupation of a field will not be lightly inferred. *See Florida Lime & Avocado Growers.* Absent federal legislation a state may impose a system of taxation as long as that system is "within the restraints imposed by the Commerce Clause itself." *City of Philadelphia v. New Jersey*, 437 U.S. 617, 623 (1978).

Applying traditional pre-emption analysis to this case, California's tax is not pre-empted. There is no specific federal statute with which the tax conflicts and there is no evidence of Congressional intent to pre-empt the field, as indeed there could not be.

The pre-emption test developed in *Japan Line*, to be applied when foreign commerce is at issue, requires that state taxation be pre-empted if it interferes with the "achievement of federal uniformity," 441 U.S. at 450, in what is "pre-eminently a matter of national concern."[16] *Id.* at 448. The broad test enunciated by the *Japan Line* Court would pre-empt a state tax on the basis of a general national policy. *Id.* at 453. The *Japan Line* Court found a national policy to remove impediments on the use of containers in international traffic, and that the county's tax interfered with this policy. *Id.* It found this policy reflected in the Customs Convention on Containers and thus could have found pre-emption of the tax under traditional pre-emption doctrine. Instead it invalidated the tax on broad grounds, stating that "it [the tax] prevent[ed] the Federal Government from 'speaking with one voice' in international trade." *Id.* at 453. By finding a general national policy sufficient to pre-empt the county's tax *Japan Line* departs from other decisions of the Court in which the "national policy" pre-emption standard for finding a conflict between federal and state law was rejected.

The "national policy" pre-emption standard established in *Japan Line* is overly broad. The pre-emption determination must be "guided by respect for the separate spheres of governmental authority preserved in our federalist system." *Alessi v. Raybestos – Manhattan, Inc.*, 451 U.S. 504, 522 (1981). The *Japan Line* standard disregards the resulting canon that federal supremacy is not lightly presumed, *Alessi*, 451 U.S. at 522, by allowing federal pre-emption to be inferred in the absence of "persuasive reasons" of the sort previously required by the Court to invalidate state laws. Because of the importance of

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16 While cases cited by the Court support the idea that uniform treatment of foreign nations is necessary, the *Michelin* Court found that a fairly apportioned non-discriminatory tax would not impair such treatment. 423 U.S. at 286. *See* n. 15, *supra*.

maintaining the state's power to act in its sphere of authority, the national policy standard has been rejected by the Court in traditional pre-emption analysis, regardless of conflict between state law and a general national policy. *Commonwealth Edison*, 453 U.S. at 633-34; *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 133 (1978); *New Motor Vehicle Board of California v. Orrin W. Fox Co.*, 439 U.S. 96, 111 (1978). Even in *Commonwealth Edison*, decided after *Japan Line*, the Court stated that it must "look beyond general expressions of 'national policy' to specific federal statutes with which the state law is claimed to conflict." *Id.* at 634 (footnote omitted). In that case the Court agreed that a national policy existed to encourage the use of coal and other alternative fuels instead of petroleum products and natural gas. However, the Court refused to find that this general policy was evidence of a Congressional intent to pre-empt any state regulation which might have an adverse impact on the use of coal. *Id.* Similarly, in *Exxon Corp. v. Governor of Maryland* the Court refused to invalidate a state law which regulated the retail distribution of gasoline even though the law was in conflict with the "basic national policy favoring free competion" which was embodied in the Sherman Act. 437 U.S. at 133. Under the rulings of *Commonwealth Edison* and *Exxon Corp. v. Governor of Maryland*, the existence of a national policy favoring arms-length reporting is not sufficient to pre-empt California's tax, absent a specific federal statutory mandate.

However, even under the broad test announced in *Japan Line* California's tax would not be pre-empted because Container has not shown the existence of even a general national policy with respect to state taxation of multinational corporations. Container argues that California's imposition of a tax determined by apportionment of its multinational income interferes with a federal policy favoring the use of arms-length reporting. This federal policy, Container argues, may be drawn from regulations

promulgated under the Internal Revenue Code and various tax treaties which embody federal schemes for taxing income of multinational corporations. (Brief of Appellant at 29-31) Container cites no specific Congressional action which requires the states to employ arms-length reporting[17] but argues that Congressional intent to pre-empt California's apportioned tax may be inferred from the federal policy. Case law dictates that this inference not be made.

In addition to stating its general reluctance to infer pre-emption, *Exxon Corp. v. Governor of Maryland,* 437 U.S. at 132, the Court has specifically stated that absent an "explicit directive from Congress, [the Court] cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States," *Mobil,* 445 U.S. at 448, because of the "well-established norm" of "[c]oncurrent federal and state taxation." *Id.* The federal regulations and treaties providing for federal taxation of multinational corporations cited by Container are not germane to the issue of state income taxation. *Cf. Mobil,* 445 U.S. at 448. Congress has not issued a directive on the states' power to tax multijurisdictional corporations. This "is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income." *Id.* The constitutional taxing system, principles of federalism,[18] the states' sovereign right to

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17 Congress has not taken such a position. *See Mobil,* 445 U.S. at 448.

18 *See* Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 MICH.L. REV. 113, 170-71 (1980).

tax[19] and case law preclude a finding that the mere existence of a federal policy for federal taxation of multinational corporations pre-empts state taxing schemes.

Container cites *Moorman*, 437 U.S. at 280, in support of its federal uniformity argument, stating that "the freedom of the States to formulate independent policy in [the] area [of commerce] may have to yield to an overriding national interest in uniformity." (Brief of Appellant at 38) While this quote from *Moorman* is accurate, it is incomplete. The portion omitted by Container makes it clear that this freedom may only yield when Congress enacts "legislation requiring all States to adhere to uniform rules for the division of income." 437 U.S. at 280. *Moorman* clearly holds that "[i]t is to that body [Congress], and not this Court, that the Constitution has committed such policy decisions."[20] *Id.; Accord Common-*

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19 The power to tax is a fundamental attribute of sovereignty, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824), is "retained by the states. . . [and] is not abridged by the grant of a similar power to the government of the Union . . . [and] is to be concurrently exercised by the two governments. . ." *McCullock v. Maryland*, 17 U.S. (4 Wheat.) 316,425 (1819); *accord Ward v. Maryland*, 79 U.S. (12 Wall.) 418 (1870); *Lane County v. Oregon*, 74 U.S. (7 Wall.) 71 (1869).

20 The entire quote from *Moorman* reads:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.

437 U.S. at 280.

wealth Edison, 453 U.S. at 628. Congress has not acted. *Mobil*, 445 U.S. at 448. Therefore, California's tax must stand.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 13th day of October, 1982, I, Lisa Gillard Gmuca, a member of the bar of the Supreme Court, caused to be mailed, postage prepaid, three copies of the foregoing Brief of the State of New Mexico as Amicus Curiae in Support of the Franchise Tax Board to Franklin C. Latcham, Counsel for Appellant, One Market Plaza, Spear Street Tower, San Francisco, California 94105 and to George Deukmejiian, Attorney General, and Neal J. Gobar, Deputy Attorney General, Counsel for Appellee, at 110 West A Street, Suite 700, San Diego, California 92101. I further certify that all parties required to be served have been served.

LISA GILLARD GMUCA
Assistant Attorney General

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CLERK

No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

against

FRANCHISE TAX BOARD,
Appellee.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

Brief on Behalf of the State of New York as Amicus Curiae

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Question Presented.

While several questions are presented in appellant's brief, this brief is limited to the question of whether the Due Process and Foreign Commerce Clauses of the United States Constitution prevent States from imposing properly apportioned franchise taxes measured by income on corporations with worldwide income derived from a unitary business.

Table of Contents.

Page

Table of Authorities ii

Interest of Amicus Curiae 1

ARGUMENT:

POINT I. Unitary based tax reporting does not violate the Due Process Clause of the United States Constitution 3

POINT II. The provisions of the Internal Revenue Code and various United States Treaties do not restrict and cannot be deemed to restrict the States' taxing power under the Foreign Commerce Clause 14

CONCLUSION. Since California has not exercised its taxing power in an extraterritorial manner and has not violated the Foreign Commerce Clause, the decision of the California Court of Appeals should be affirmed 19

TABLE OF AUTHORITIES.

CASES:

Butler Brothers v. McColgan, 315 US 501 (1942) ... 3, 4

Complete Auto Transit, Inc. v. Brady, 430 US 274 (1977) 15

Exxon Corp. v. Wisconsin Department of Revenue, 447 US 207 (1980) 4

General Motors Corp. v. Washington, 377 US 436 (1964) 3

Page

Hans Rees' Sons v. North Carolina, 283 US 123 (1931) 3, 4

International Harvester v. Evatt, 329 US 416 (1947) 4, 8, 10

Japan Line, Ltd. v. County of Los Angeles, 441 US 434 (1979) 14

Mobil Oil Corp. v. Commissioner of Taxes, 445 US 425 (1980) 3, 4, 11, 16, 17

Moorman Manufacturing Co. v. Bair, 437 US 267 (1978) 3, 10

Norfolk and Western Railroad Co. v. Missouri State Tax Commission, 390 US 317 (1968)..... 8

Northwestern States Portland Cement Co. v. Minnesota, 358 US 450, 460 (1959) 3, 4

Underwood Typewriter Co. v. Chamberlain, 254 US 113 (1920)..... 3, 9, 10

United States Steel Corp. v. Multistate Tax Commission, 434 US 452 (1978)..... 4

UNITED STATES CONSTITUTION:

Article I, Section 8, Clause 3 14

Due Process Clause 3, 9

Foreign Commerce Clause 15, 18

Page

UNITED STATES STATUTES AND REGULATIONS:

Internal Revenue Code, § 482 12

Reg, § 1.482, *et seq.* 12

NEW YORK STATUTES:

Tax Law, § 211, subd 4-a 2

Tax Law, § 211, subd 5 5

20 NYCRR 6-2.1 through 6-2.7 (Business Corporations Franchise Tax Regulations) 2

CALIFORNIA STATUTES:

Revenue and Taxation Code, §§ 25128, *et seq.* 6

MISCELLANEOUS:

HR 5076, 96th Cong, 2d Sess (Hearings before House Committee on Ways and Means on State Taxation of Foreign Source Income, March 31, 1980, Serial 96-81)..... 17

J. Hellerstein, *State and Local Taxation*, 400 (3d ed, 1969)..... 4

P-H Federal Taxes, Tax Treaties II, ¶ 89,001 at 89,003 ..... 17, 18

P-H Federal Taxes, Tax Treaties, II, ¶ 89,001 at 89,007 ..... 17, 18

Page

P-H Federal Taxes, Tax Treaties II, ¶ 89,030, *et seq.* 17

P-H Federal Taxes, Tax Treaties II, ¶ 89,039, at 89,038 17

The President's 1978 Tax Program 11, 13

United States/United Kingdom Income Tax Treaty . 17

124 Cong Rec 5132 and 6520 16

89 Harv L Rev 1202, Geoffry John Harley, "International Division of the Income Tax Base of Multination Enterprise" 11

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ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT.

Brief on Behalf of the State of New York as *Amicus Curiae.*

Interest of *Amicus Curiae*

Container Corporation of America ("Container") challenges long-standing interpretations of law upholding the constitutionality of certain statutes under which New York State and other States are collecting franchise taxes.

These statutes apportion to a state part of the worldwide income of a corporation attributable to that state based upon the unitary business principle.* A decision adverse to the California Franchise Tax could require New York and

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*Under its Franchise Tax on Business Corporations, pursuant to section 211, subdivision 4-a of the Tax Law, New York State requires certain oil companies which are engaged in a unitary business to report their income in the manner just described. Subdivision 4-a provides as follows:

> "4-a. In the case of a taxpayer subject to tax under this article and which also comes within the definition of oil company, as such term is defined in subdivision two of section one hundred eighty-two-a of this chapter, which owns or controls, either directly or indirectly, more than fifty percent of the capital stock of one or more other corporations, or more than fifty percent of the capital stock of such taxpayer is owned or controlled, either directly or indirectly, by one or more other corporations or more than fifty percent of the capital stock of such taxpayer and one or more other corporations are owned or controlled, either directly or indirectly, by the same interests, the tax commission shall require the filing of a report showing the entire net income and capital of each of those corporations, whether or not such corporations are taxpayers, and such other information as it deems necessary. If, in order to reasonably attribute to this state a fair and proper portion of the income and capital of such taxpayer, or either of such items: (a) income or capital, or one or more or any portion of such items, of one or more of such corporations, must be treated as the income and capital of such taxpayer; or (b) the income, capital or deductions, or one or more or any portion of such items, must be apportioned or allocated between or among such taxpayer and such other corporations then the tax due by such taxpayer under this article shall be computed."

Under its Franchise Tax on Business Corporations, pursuant to section 211, subdivision 4 of the Tax Law, New York can require or permit corporations not required to report under subdivision 4-a of section 211 of the Tax Law to report income and capital on a combined basis where the corporations are part of a unitary business conducted by the entire group of corporations and certain other conditions are met. See Business Corporation Franchise Tax Regulations, 20 NYCRR 6-2.1 through 6-2.7.

other States to change their existing fair methods for reporting franchise taxes in the case of multinational corporations. If this Court's decision were to mandate such a change, the administration of corporate taxes by the States would be more difficult and less practical and income properly attributable to the various states of the United States would escape taxation.

ARGUMENT

POINT I

Unitary based tax reporting does not violate the due process clause of the United States Constitution.

It is settled beyond question that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Northwestern States Portland Cement Co. v. Minnesota,* 358 US 450, 460 (1959); *General Motors Corp. v. Washington,* 377 US 436 (1964); *Mobil Oil Corp. v. Commissioner of Taxes,* 445 US 425, 436-442 (1980). See also, *Underwood Typewriter Co. v. Chamberlain,* 254 US 113 (1920); *Hans Rees' Sons v. North Carolina,* 283 US 123 (1931); *Butlers Brothers v. McColgan,* 315 US 501 (1942); *Moorman Manufacturing Co. v. Bair,* 437 US 267 (1978). In determining what constitutes "fairly apportioned", this Court has enunciated the following standard:

> "That the apportionment may not result in mathematical exactitude is certainly not a constitutional defect. Rough approximation rather than precision is, as a practical matter, the norm in any such tax system." *Illinois Central Railroad Co. v. State of Minnesota,* 309 US 157, 161 (1940), reh den, 309 US 695 (1940).

In *Mobil Oil Corp., supra,* 445 US at 439, this Court observed that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle" (footnote omitted). In accordance with this principle, the Court has upheld state apportionment formulas, such as that of California, which combine the income of several related corporations engaged in a "unitary" business. Income is generally allocated to the taxing State by multiplying the total net income of the enterprise by a percentage comprised of the average of the ratios of in-state property, payroll, and sales to total property, payroll and sales. See, *United States Steel Corp. v. Multistate Tax Commission,* 434 US 452, 475 n 25 (1978); *Exxon Corp. v. Wisconsin Department of Revenue,* 447 US 207, 214 n 3 (1980); *Mobil Oil Corp., supra,* 445 US at 429-430 nn 2-4. A unitary business is one in which all of the corporate constituents are involved in an economically functionally-related enterprise. As one leading commentator has observed, the "very essence of formulary apportionment [is] that where there are integrated, interdependent steps in the economic process carried on by a business enterprise, there is no logical or viable method for accurately separating out the profit attributable to one step in the economic process from other steps." J. Hellerstein, *State and Local Taxation,* 400 (3d ed, 1969). See also, *Butler Brothers, supra,* 315 US at 508; *Hans Rees' Sons, supra,* 283 US at 133.

Logically, it is impossible, when a tax is fairly apportioned, to have the same income taxed twice by the several States. See, *Northwestern States Portland Cement Co. v. Minnesota,* 358 US 450 *(supra).* Allocation formulas may not, however, always reflect income of corporations solely within a State. This fact has not been considered to be a sufficient basis for holding that they deprive corporations of Due Process or infringe upon the Commerce Clause. *International Harvester v. Evatt,* 329 US 416 (1947). In cases where application of the formula results in income

allocable to a State being improperly reflected, this Court and the States have provided for the adjustment allocation formulas. This is shown, for example, by New York Tax Law, § 211, subd 5.*

We may note that it has been New York State's recent experience that tax reporting on a unitary basis has not consistently resulted in more State corporate taxes being exacted than would be the case if the corporations were treated as separate and independent.

In the instant case, the Court of Appeal of the State of California found that Container Corporation of America did not meet its burden of showing by clear and cogent

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*New York Tax Law, § 211, subd 5 provides:

> "5. In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income, deductions and capital, and to eliminate assets in computing any allocation percentage provided only that any income directly traceable thereto be also excluded from entire net income, so as equitably to determine the tax. Where (a) any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (b) any taxpayer, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, enters into any transaction with such other corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income of the taxpayer the fair profits which, but for such agreement, arrangement or understanding, the taxpayer might have derived from such transaction."

evidence that extraterritorial values were being taxed. If those conditions are adequately based on the record, the principles announced by the Court fully support the interpretation of California's tax.

Container argues that the method under which a part of its worldwide income is apportioned to California is a method which cannot be applied to Container because the differing wage and profit rates of the foreign countries in which it does business render the formula so inexact as to constitute extraterritorial taxation in violation of the Due Process Clause. In the instant case, the California court found that Container and its foreign subsidiaries were a unitary enterprise and, thus, apportionment of worldwide income could be used as the method for measuring the income subject to California's franchise tax. Assuming that the facts of this case support the finding of a unitary enterprise, an examination of the facts revealed by Container's brief shows that the apportionment of its worldwide income produces an attribution of income which is well within the standards required by the Due Process Clause.

Container's attack on the apportionment of its worldwide income centers on its contention that the wage rates which its foreign subsidiaries must pay are considerably lower than the wages it must pay in the United States. One of its larger subsidiaries operated in Germany during the relevant years where the amount of wages required to produce a dollar of net income exceeded the amount required to be paid in the United States (Applt Br, pp 17, 18). Container admits that the wage rates in "the more advanced industrial countries are, in recent years, approaching, and in some cases exceeding, those in the United States * * *" (Applt Br, p 12). Moreover, Container's statistics regarding the alleged expected higher rate

of return from investment in the less industrialized countries, which presumably are attributable to lower wages, do not take into account the risks caused by political and social conditions in these countries which can result in large and catastrophic losses in later years.

In any event, the wage factor is only one of three factors used to apportion the combined income of Container and its subsidiaries. California Revenue and Taxation Code, §§ 2528, *et seq.* The other factors of sale and property must also be considered. The chart found on page 18 of Container's brief alleges the dollar amount of sales, payroll and property required to produce $1.00 of net income for Container's domestic and foreign subsidiaries. Of the five foreign countries listed, the United States required sales of $10.65; Mexico—$10.69; and in Germany—$17.62 to produce a dollar of profit. The average sales required to produce a dollar of profit in the five foreign countries listed on the chart is $9.24 or 86.76 percent of the $10.65 required in the United States.

A similar analysis of the property factor shows that the average amount of property required to produce a dollar of profit in the five foreign countries listed is $5.15, a higher amount than required in the United States.

The total combined net income of Container and its subsidiaries is listed at $41,710,000. Calculated by the worldwide apportionment method, a pre-tax yearly average of $32,068,000 was attributed to the United States; whereas, $28,121,000 was attributable to this country if it were allocated by the separate accounting method (Applt Br, p 17). Thus, the difference between the two methods equals $3,947,000 ($32,068,000 – $28,121,000), or 9.46 percent of the total combined income ($3,947,000 ÷ $41,710,000). This 9.46 percent must be divided among all 50 States, or at least those States in which Container

does business. Thus, when all the factors are considered in this case, even using Container's figures as we have done, the difference resulting from the use of the two different allocation formulas, neither of which is perfect, is relatively small. The amount of sales required to produce a dollar of net income is substantially the same as in this country and the value of property required to produce a dollar of net income is, based on Container's own figures, actually higher. This would indicate that the method used by California, under which worldwide income is apportioned is, in fact, a reasonable and fair system of attributing income to California or other States using that method. Moreover, as our discussion suggests, there is no basis for assuming that the method used here has any inherent basis in favor of reaching extraterritorial profits.

This Court said in *International Harvester Co. v. Evatt*, 329 US 416, 422 (1947):

> "Furthermore, this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive complex business activities such as those of appellant, and has declared that 'rough approximation rather than precision' is sufficient."

Throughout the due process portion of its brief, Container has relied most heavily on *Norfolk and Western Railroad Co. v. Missouri State Tax Commission*, 390 US 317 (1968). An examination of the *Norfolk and Western* case shows that it is inapplicable to this case because it dealt with the taxation of property and not income. *Norfolk and Western*, invovled the validity of Missouri's mileage based apportionment formula used in connection with an *ad valorem* tax on railroad rolling stock. Thus, the question was whether the property being taxed was located in the State since "taxation of property not located in the taxing State is constitutionally invalid * * *." *Id.*, at 325.

Up to now, we have defended the apportionment of worldwide income as a method which is within the tolerances allowed by the Due Process Clause of the United States Constitution. Based upon principles long recognized by this Court, however, this method has much to commend it as a fair and realistic method of attributing income to a State. Indeed, this conceptual soundness not only serves to bring worldwide apportionment even further within allowable constitutional tolerances, but also it once more shows that the statistical and separate accounting approaches taken by Container are a highly dubious means of accurately attributing income. Moreover, this Court has made it clear that the States are not limited to a single formula in assessing taxing of the type involved here.

In *Underwood Typewriter Co. v. Chamberlain,* 254 US 113, 117 (1920), this Court was called upon to decide the validity of the application of Connecticut's single-factor property apportionment formula to Underwood's operations. Even though only 3 percent of its profts were due to sales in Connecticut, Underwood's manufacturing and storage facilities were located in that State. *Id.*, at 119, 120. Thus, using the single-factor property formula, 47 percent of its profits were apportioned to Connecticut. *Id.*, at 120. In sustaining the apportionment formula against a due process attack, the Court stated:

> "The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with sale in other states. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the process conducted with its borders. It therefore adopted a method of apportionment which, for all that ap-

> pears in this record reached, and was meant to reach, only the profits earned within the state." *Id.* at 120-21.

(The *Underwood* case was cited with approval and was deemed controlling in *Moorman Manufacturing Co. v. Bair,* 437 US 267, 273-74 [1978].)

In attempting to attribute to California the combined income of Container and its foreign subsidiaries, all of which corporations are linked by way of the conduct of a unitary business, California's legislature had a choice to make between the separate accounting and worldwide apportionment methods. It chose the method under which worldwide income is apportioned because that method takes into account numerous organizational and functional factors which have a bearing on "the process conducted within its borders" (*Underwood Typewriter Co., supra,* at 121) and because the method is admirably suited to the "expansive, complex business activities such as those of appellant" (*International Harvester Co., supra,* at 422). The lower court recognized these facts when it stated:

> "The evidence appellant [Container] presented with respect to the disproportionality of income allocation is not compelling. It fails to account for contributions to income which result from the functional integration and centralization of management which exist in a unitary operation. It is 'misleading to characterize the income of the business as having a single identifiable "source". Although separate geographic accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required'." *Container Corp. of America v. Franchise Tax Board,* 117 Cal App 3d 988, 1004 (Cal Ct App, 1981).

When Container relates the figures it computes on a geographic basis for wages, sales and property to the "income" which it asserts to be correct on a geographic basis, it does so using the "income" it computes for its own bookkeeping purposes or for Federal tax purposes and not the income of the unitary business. By ignoring the income of the unitary business, Container ignores the fact that factors of payroll, sales and property located in one geographic area may produce net income recorded on the books in another geographic area. With a unitary business, there is no way that the profits attributable to interrelated activities can be separated. *Mobil Oil Corp. v. Commissioner of Taxes,* 445 US 425, 438 (1980). Thus, Container's figures do not support a conclusion based on constitutional principles that the apportionment of worldwide income attributes more taxable income to California than does Container's own bookkeeping methods.

The separate accounting and arm's-length methods which Container claims are the only constitutionally permitted methods for multinational corporations have been subjected to substantial adverse criticism. This criticism has come from legal scholars (89 Harv L Rev 1202, Geoffry John Harley, "International Division of the Income Tax Base of Multination Enterprise"), The Treasury itself (The President's 1978 Tax Program, January 30, 1978, pp 282-297), and the General Accounting Office ("IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981) among others.

The approach is, moreover, theoretically wrong because the separate entity approach does not conform to economic reality. Commonly controlled corporations are aware that additional benefits to the business as a whole may be derived from dealing with one another; therefore,

they do so. Economies of scale and reduced transaction costs may result where commonly controlled companies contribute either horizontally or vertically to a single production-distribution process. Centralized management control may produce efficiencies in management in raising capital, in obtaining quantity discounts and in advertising. Diversification of risk creates potential savings even where there are few similarities between affiliates. Policital and economic power, which may be used to increase long-run profits of the whole multinational corporation, may stem from large size alone regardless of the degree of compatibility between the affiliates.

As an aid in administering the system, section 482 of the Internal Revenue Code provides the Federal Internal Revenue Service with policing power. It provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or business."

The Department of Treasury has adopted implementing regulations (Reg, §1.482, *et seq.*). These regulations attempt to compare intercorporate transactions to those conducted by separate entities. It views each corporation as separate and independent and uninfluenced by the existence or opportunities to deal with related entities. As

pointed out in the President's 1978 Tax Program, *supra,* pp. 286-287, the regulations are only a partial solution even for Federal taxation:

> "The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions * * *. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. Tax revenues can be substantial.
>
> "Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices."

Even the courts have commented on the administrative and expense problems involved.

> "As evidenced by the magnitude of the record compiled in this case, the resolution by trial of a reallocation controversy under section 482 can be a very burdensome, time-consuming and obviously expensive process—especially if the stakes are high. A more manageable and expeditious means of resolution should be found." *E. I. DuPont DeNemours and Co. v. US,* 608 F2d 445 (Ct Cl, 1979).

POINT II

The provisions of the Internal Revenue Code and various United States treaties do not restrict and cannot be deemed to restrict the states' taxing power under the Foreign Commerce Clause.

Article I, Section 8, Clause 3 of the United States Constitution provides that Congress shall have the power "to regulate commerce with foreign Nations and among the several States, * * *". This Court has interpreted the Commerce Clause as only prohibiting state taxes which interfere with or discriminate against interstate or foreign commerce. Although a burden on commerce, as are all taxes, state taxes imposed on the unapportioned gross receipts from business activities in the taxing State, or net income apportioned to reflect fairly business activities in the taxing State, have been held constitutional.

In arguing that California's tax on Container violates the Foreign Commerce Clause, Container relies upon this Court's decision in *Japan Line, Ltd. v. County of Los Angeles,* 441 US 434 (1979). However, *Japan Line* dealt with an *ad valorem* property tax on instrumentalities of foreign commerce; whereas, this case is concerned with a franchise tax measured by the income of a group of multinational corporations linked together as a unitary business. In distinguishing the *Japan Line* case, this Court in *Mobil* pointed out a basic fact which makes the *Japan Line* case inapplicable to the *Container* case as well:

> "Appellant's attempted analogy between this case and Japan Line strikes us as forced. That case involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. As has been noted, the factors favoring use of the

> allocation method in property taxation have no immediate applicability to an income tax." *Mobil Oil Corporation v. Commissioner of Taxes,* 445 US 425, 447 (1980).

The analysis of any question involving state taxation and an alleged Commerce Clause violation must begin, of course, with the criteria set forth in *Complete Auto Transit, Inc. v. Brady,* 430 US 274 (1977). It was held in *Complete Auto* that a state tax constitutes an impermissible burden on interstate commerce if it is found

> "that the activity is not sufficiently connected to the State to justify a tax, or that the tax is not fairly related to benefits provided the taxpayer, or that the tax discriminates against interstate commerce, or that the tax is not fairly apportioned." *Id.,* at 287.

Container asserts that, because worldwide apportionment conflicts with the separate accounting system set forth in the Internal Revenue Code and in various United States treaties, such an apportionment method impairs the ability of the United States to implement a uniform foreign policy, hence violating the Foreign Commerce Clause. In essence, Container advances the proposition that the provisions of the Code and various treaties imply a restriction on the states' taxing power; specifically, that the States are prevented from using worldwide apportionment and are required to use separate accounting when measuring the income of taxpayers who have foreign source revenue. However, this Court has steadfastly refused to allow such restrictions to be imposed upon the States by implicit operation of the Foreign Commerce Clause. This has been the case whether such implications are argued to have arisen by virtue of the Internal Revenue

Code or treaties,* or both. Moreover, the absence of any explicit Federal mandate and, indeed, Congress' express rejection of such restrictions clearly reveals an intention not to so restrict the States.

To begin with, this Court ruled in *Mobil Oil Corp.* that a restriction on the states' power to include foreign-source dividends in a taxpayer's tax base cannot be inferred from Federal "statutes and treaties":

> "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil Corp., supra* at 448.

This ruling in *Mobil Oil Corp.* reiterates the long-standing position taken by this Court that the provisions of treaties will not be expanded by implication to restrict an entirely proper and constitutional exercise of power by the States:

> "Even the language of a treaty wherever reasonably possible will be construed so as not to override state laws or to impair rights arising under them." *Guaranty Trust Co. of New York v. United States,* 304 US 126, 143 (1938). (See cases cited in support of the above quote, which go back to 1832.)

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*We note that the constitutionality of regulating the States' power to tax by treaty-making, thereby bypassing the House of Representatives and various Congressional committees in the establishment of Federal tax policies, has been questioned. See, e.g., 124 Cong Rec 5132 and 6520 (remarks of Senator Gravel and Senator Stevens, respectively). However, this question need not even be reached in this case since, as will be shown below, the Senate has rejected efforts to so regulate the States. Indeed, we also note that neither Container, nor the Solicitor General in its *amicus* brief in the *Chicago Bridge & Iron* case, base this aspect of their argument on the treaty-making clause. Thus, the statements in this brief should not be taken as an expression in support of the constitutionality of restricting the States' taxing power solely by treaty.

Container's contention in this regard not only runs afoul of the Court's refusal to infer such restrictions, but also it is a position which is belied by the facts. Examples of Congress' flat rejection of such express restrictions abound, both in the context of legislation and treaties. With respect to legislation, the Federal government has not chosen to prevent the States from using formulas which apply to State aspects of interstate and international activities or operations. See this Court's discussion in *Mobil Oil Corp., supra,* 445 US at 448-49. Since that time, Congress has again considered the problem of combined reporting and its effects on interstate and foreign commerce. Proposed legislation which was designed to preempt the States from taking foreign value into account and thereby overturning *Mobil* was considered by the House Committee on Ways and Means, but the proposal was permitted to die without any action. See H R 5076, 96th Cong, 2d Sess; Hearing before House Committee on Ways and Means on State Taxation of Foreign Source Income, March 31, 1980, Serial 96-81, e.g. at pp 1-2.

With respect to treaties, a rather dramatic example of Congress' intention not to so restrict the States is found in the history leading up to the ratification of the United States/United Kingdom Income Tax Treaty (hereinafter referred to as the "U.K. Treaty".) (See *P-H Federal Taxes, Tax Treaties II,* ¶ 89,030, *et seq.*, at 89,031, *et seq.* for the official title and full text of the U.K. Treaty). When the U. K. Treaty was submitted to the Senate for advice and consent to ratification, it contained, in paragraph 4 of Article 9, a provision which explicitly prohibited the States from using worldwide apportionment for taxation of U. K. enterprises and subsidiaries. *P-H Federal Taxes, Tax Treaties II,* ¶ 89,001, at 89,003 and ¶ 89,003, at 89,007. (See *P-H Federal Taxes, Tax Treaties II,* ¶ 89,039, at 89,038 for the text of Article 9[4]). At the time, it was

recognized, even by the U. K. Treaty's proponents,* that an express restriction of the States' taxing power was something which had not been attempted previously:

> "The proposed treaty contains a new provision, *not found in other United States tax treaties,* which places limitations on the combined reporting method used by several states of the United States to determine the taxable income which multinational corporations derive from sources within the State." Report of the Senate Committee on Foreign Relations, Exc Rept No 95-18, 95th Cong, 2d Sess, found in *P-H Federal Taxes, Tax Treaties II,* ¶ 89,070, at 89,100-1 (emphasis added).

However, when the U. K. Treaty reached the floor of the Senate, paragraph 4 of Article 9 was eliminated by reservation. Accordingly, the Treaty was ultimately ratified by the Senate in 1979 without the inclusion of the restriction. *P-H Federal Taxes, Tax Treaties II,* ¶ 89,001 at 89,003 and ¶ 89,003, at 89,007.

Despite clear evidence that Congress has not intended to restrict the states' use of worldwide apportionment, Container argues that such restrictions should be implied from the Internal Revenue Code and various treaties. This Court's refusal to impose such restrictions by implication is a clear admonition to parties such as Container that this Court will not act where Congress has refused to act. Thus, Container's contention that worldwide apportionment violates the Foreign Commerce Clause is without merit.

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*The Senate Foreign Relations Committee recommended to the entire Senate that the U. K. Treaty, including Article 9(4), be ratified. See Report of the Senate Committee on Foreign Relations, Exc Rpt No 95-18, 95th Cong, 2d Sess, found in *P-H Federal Taxes, Tax Treaties II,* ¶ 89,070, at 89,100-L through 89,100-M.

CONCLUSION

Since California has not exercised its taxing power in an extraterritorial manner and has not violated the Foreign Commerce Clause, the decision of the California Court of Appeal should be affirmed.

Dated: Albany, New York
September 28, 1982

Respectfully submitted,

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No. 81-523

In The

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

vs.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court of Appeal Of The State Of California For The First Appellate District

BRIEF OF AMICUS CURIAE STATE OF NORTH DAKOTA IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

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TABLE OF CONTENTS

Pages

Table of Authorities i

Interest of Amicus Curiae State of North Dakota 1

Argument 2

Summary of Argument 19

Conclusion 21

TABLE OF AUTHORITIES

CASES

Adams Express Company v. Ohio State Auditor, 165 U. S. 194 (1897) 8, 18

ASARCO Inc. v. Idaho State Tax Commission, — U. S. —, 50 Law Week 4962 (1982) 10, 19, 20, 21

Butler Brothers v. McColgan, 315 U. S. 501 (1942) 6, 9

Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 Pac. 2d 16 (1947) 15, 16

Exxon Corporation v. Wisconsin Department of Revenue, 447 U. S. 207 (1980) 9

F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico, — U. S. —, 50 Law Week 4957 (1982) 10, 19, 20, 21

Honolulu Oil Corporation v. Franchise Tax Board, 60 Cal. 2d 417, 386 Pac. 2d 40 (1963) 6, 11

Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U. S. 425 (1980) 10, 13, 17, 20

TABLE OF AUTHORITIES—Continued

Pages

Superior Oil Company v. Franchise Tax Board, 60 Cal. 2d 406, 386 Pac. 2d 33 (1963) 6, 11

Underwood Typewriter Company v. Chamberlain, 254 U. S. 113 (1920) 9, 18

Union Pacific Railway Company v. Cheyenne, 113 U. S. 516 (1885) 7, 8

STATUTES

Chapter 57-38, North Dakota Century Code 1

Chapter 57-59, North Dakota Century Code 1

REGULATIONS

Multistate Tax Commission, Regulation IV.1.(b) 1, 2

North Dakota Administrative Code, Section 81-03-09-04 ..... 1, 3

OTHER AUTHORITIES

1981 B. Y. U. Law Review 87 13

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BRIEF OF AMICUS CURIAE STATE OF NORTH DAKOTA IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

Interest of Amicus Curiae State of North Dakota

The State of North Dakota imposes a corporation net income tax, Chapter 57-38 of the North Dakota Century Code, and has enacted the Multistate Tax Compact, Chapter 57-59 of the North Dakota Century Code. The North Dakota State Tax Commissioner is charged with the administration of these two laws and has duly adopted and promulgated regulations for the administration of them. Those regulations include Section 81-03-09-04 of the North Dakota Administrative Code. That regulation is the same as Multistate Tax Commission Regulation IV.1.(b), part of which is quoted below at the beginning of the Argument in this brief.

The North Dakota State Tax Commissioner in auditing and assessing multistate and multinational corporations has applied the same income apportionment principles as those applied by the California Franchise Tax Board in the case on appeal here. The interest of the State of North Dakota in this appeal therefore parallels that of the Appellee, the Franchise Tax Board.

ARGUMENT

A Corporation Involved In A Single Business Is Unitary

The Multistate Tax Commission Regulations

Reg. IV.1.(b) of the Apportionment Regulations Adopted Under Article IV of the Multistate Tax Compact provides in part:

> Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.
>
> • • •
>
> The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or

contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(1) Same type of business. A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

Under this regulation adopted by the Multistate Tax Commission, California, and other states, including North Dakota which has adopted it as North Dakota Administrative Code § 81-03-09-04, a presumption is created that a single business exists when the same activities are carried on in every state by a single corporation.

Presumptions may be of fact, of law, or a mixture of both. The presumption set forth in the Multistate Tax Commission regulation, while not specifically classified, may reasonably be described as a presumption of fact. According to Black's Law Dictionary, "Presumptions of fact are not the subject of fixed rules, but are merely natural presumptions, such as appear, from common experience, to arise from the particular circumstances of any case. . . . They may be said to be the conclusions drawn by the mind from the natural connection of the circumstances disclosed in each case, or, in other words, from circumstantial evidence." To be valid a presumption must be based in reason or common experience. The presumption set forth in the regulation meets this criterion and should be followed by the Court in this case.

4

COMMON SENSE

Take a businessman who operates a particular enterprise and has developed experience in the vagaries of that individual business in which he engaged. If our businessman operates a grocery store he has learned that general climatic conditions affect the products sold. He has learned that the placement of goods at particular shelf levels influences the amount of sales. He has also learned the importance of store location and parking and a myriad of other details. Some, but not all, of this experience will be transferable to operating a gas station or a drug store. Very little of it will be useful if our businessman attempts to operate a steel foundry.

Assuming our businessman wishes to expand his business, is he more likely to buy a steel mill or another grocery store? Clearly, the grocery store. If he locates in another area with different climate and clientele, he will discover his product mix must be different, but many of the fundamentals of the business remain the same. He will have learned many lessons from operating his first business which will prevent mistakes in his second business. He will have a leg up on an erstwhile competitor who attempts to enter a business with no experience.

Not only will our businessman profit from his past experience, he will also profit from his past contacts. Suppliers will know him and he will have established a track record. Credit will be easier to obtain, discounts may be forthcoming, and an array of other intangible benefits may flow.

Suppose our businessman's operation has become quite large. In the past he found it feasible to set up stores only in established areas in order to generate necessary volume. But with size comes the opportunity for strategic planning. Our businessman has the resources to enter into newly developing areas. A store in such an area can be carried by the business as a whole while the neighborhood develops. But, once it develops, the store may be even more lucrative. The store obtains a toe-hold and can grow with the neighborhood. It builds its clientele with the neighborhood, it establishes shopping habits, it creates loyalty. But, it was not a separate business when it started and it is not a separate business when it matures. It remains part of the same business and supports new additions as it was once supported. It does not compete with other members of the business, it supplements them. Each store is stronger for its association with the other stores.

This is the principle behind the presumption in the regulation. It exists and it is real. The contributions involved are not susceptible of valuation, however. Common sense tells us they exist, but no science can quantify the difference resulting from such interaction. The existence of this interaction and the synergistic benefits involved is one of the principal justifications for reliance on the unitary business concept by the states and for its acceptance by the courts.

DECISIONS BY THE CALIFORNIA COURTS

It is particularly aproriate that this Court has before it a case involving the State of California. California has

been one of the pioneers in developing and rationalizing state income taxation. *Butler Brothers v. McColgan,* 315 U.S. 501 (1942), is a California case. Two landmark cases in the development of the unitary concept are the companion cases of *Superior Oil Co. v. Franchise Tax Board,* 60 Cal. 2d 406, 386 Pac. 2d 33 (1963), and *Honolulu Oil Corp. v. Franchise Tax Board,* 60 Cal. 2d 417, 386 Pac. 2d 40 (1963). These decisions are worthy of review by this Court. Both cases involved oil companies that were engaged in the exploration, production and sale of crude oil products in several states. "Generally, raw production was sold at the well site to other companies. All production in California was sold in California, and all out-of-state production was sold outside of California." (pp. 408 and 420.) Over the objections of the Franchise Tax Board and incidentally at the pleadings of counsel for Appellant, Container Corporation of America (hereinafter "CCA"), the Courts found that the single corporation conducted a unitary business.

In *Superior,* the trial court found, and the California Supreme Court accepted, that:

> "California business operations contributed substantially to the out-of-state portion" of its business in areas relating to executive policy making, administrative control, coordination of exploration activities, well production and land acquisition, training of technical personnel, specific scientific and technical development and testing laboratories, drilling operations and drilling equipment, manufacturing and sales, accounting, tax returns, personnel, insurance and purchasing.
>
> The court also found that "Superior's California operations were substantially dependent upon the

out-of-state operations" in areas relating to the borrowing of substantial funds on assets located outside of California in order to finance projects within California, the transfer of company funds from sources outside of California to finance projects within California, legal counseling provided by the chief counsel located in Texas and other attorneys in Washington, D. C., the supplying and control of tubular materials from Superior's Texas office and transfer of other materials to California from company sources outside of California, fiscal control from Superior's Texas office for half of the year in question, geophysical technical information and services supplied to California from the company's Texas laboratories, certain land-lease controls supplied by offices in Texas, the transfer of valuable drilling equipment from out of state for California operations, the transfer of skilled personnel from out of state for purposes of performing services in California, and the supply, on a daily basis, of technical and other information to the company's California offices in order that executive and policy decisions could be made and overall control exercised.

In essence, the California courts found that the same business was conducted in all states, or rather that a single business existed even though there were almost no physical connections between activities carried on in the various states. The connections which existed were those resulting from exchange of personnel and information and the utilization of such resources by the whole business.

UNITARY DECISIONS OF THIS COURT

The unitary business principle was first postulated by a number of western states in an effort to fairly assess property taxes. *Union Pacific Railway Company v. Cheyenne*, 113 U. S. 516 (1885). These states and their

cities were confronted with the problem of equitably spreading the tax burden among most businesses whose assets were located wholly within a single jurisdiction and businesses such as railroads and public utilities whose assets were dispersed over a number of jurisdictions. The state law sustained in *Union Pacific* provided that the value of the whole property in the state should be ascertained and then assigned proportionally, on a mileage basis, to the individual jurisdictions. The law was based on the theory that the railroad constituted a single business or unit, not a large number of separate businesses whose boundaries conformed neatly to the geographic divisions within the state.

The unitary business principle was gradually extended by the states and the courts to encompass business locations which were not tied directly to each other through a physical connection such as rails. In *Adams Express Company v. Ohio State Auditor*, 165 U. S. 194 (1897), the Court sustained the use of unitary business principles for express companies and accepted the principle that the measure of tax could be based upon a comparison of activities within a single state to those carried on everywhere by the business. In the cases presented to the Court there were no physical ties between the various locations of the express companies. All transportation, other than local delivery, was accomplished through the use of third parties such as railroads and steamship lines. As the Court stated, "The physical unity existing in the former [railroads, etc.] is lacking in the latter [express companies]; but there is the same unity in the use of the entire property for the specific purpose." (p. 221.)

The Court in passing noted that a party owning "a manufacturing establishment in one state and a store in another . . . is separate." (p. 222.) Barely twenty years later, the Court effectively rejected this bit of dictum in *Underwood Typewriter Company v. Chamberlain*, 254 U. S. 113 (1920), in holding that the unit rule applied to a business which manufactured goods in one state and sold them in several. The conclusion that a single business was being conducted was so obvious that it was not even discussed.

In *Butler Brothers*, supra, the Court considered the propriety of a California tax assessed against a single corporation engaged in the wholesaling of dry goods and general merchandise through distribution houses located in seven states. Although the Court stated that while:

> Each of its houses in the seven states maintains stocks of goods, serves a separate territory, has its own sales force, handles its own sales and all solicitation, credit and collection arrangements in connection therewith, and keeps its own books of account. (p. 504.)

there never was a question that a single business was involved. The taxpayer argued that each distribution house could be separately accounted for, and this argument was rejected on the grounds that "California may properly treat appellant's business as a unitary one. Cf. *Grant Atlantic & P. Tea Co. v. Grosjean.*, 301 US 412, 81 L Ed 1193, 57 S Ct 772." (p. 508.)

As recently as the 1979-1980 term, this Court had the opportunity to consider whether the marketing, refining and exploration departments of an oil company constituted a single business in the case of *Exxon Corporation*

v. Wisconsin Department of Revenue, 447 U. S. 207 (1980). The Court concluded they did even though the only activity engaged in in Wisconsin was marketing. Exxon, in arguing before the Supreme Court, conceded that its marketing operations constituted a single unitary business and argued only that the separate functions engaged in by the company represented distinct business activities. (Footnote 7, p. 223.) The Court accepted, without comment, Exxon's concession that its horizontal activities were unitary.

In *Mobil Oil Corporation v. Commissioner,* 445 U. S. 425 (1980), the Court indicated a predelection to holding a vertically integrated business unitary when it stated that Mobil "has made no effort to demonstrate . . . its subsidiaries and affiliates are distinct. . . . Indeed, all indications in the record are to the contrary, since . . . [they] are part of appellant's integrated petroleum enterprise." (p. 439.)

THE VIEWS OF FRANK KEESLING

This Court has frequently cited with approval the writing of Frank Keesling, who has authored and coauthored many articles on allocation and apportionment of income. (E. g., footnote 14, *Mobil Oil,* supra; footnotes 22 and 25, *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico,* — U. S. —, 50 Law Week 4957 (1982); and footnote 22, *ASARCO Inc. v. Idaho State Tax Commission,* — U. S. —, 50 Law Week 4962 (1982).) This is of course proper. Mr. Keesling has frequently been referred to as the "father of the unitary concept." He clearly was one of the originators of the combined

report procedure. (See 42 Journal of Taxation 106, Feb. 1975.)

Keesling's views have evolved as has the utilization of the unitary concept. In "California's Uniform Division of Income for Tax Purposes Act," 15 U. C. L. A. L. Rev. 156, 169 (1967), he commented on the efforts of *Superior Oil*, supra, and *Honolulu Oil*, supra, thusly:

> In deciding to what extent its policies should be altered in the light of the Superior Oil and Honolulu Oil decisions, the Franchise Tax Board seized upon this "type of business" test. If a taxpayer is engaged in one type of business within and without the state, the formula method would be used. If it is engaged in one business here and a different type of business elsewhere, separate accounting would still be appropriate. If it is engaged in two or more types of businesses, each of which is conducted within and without the state, then the net income of each business would be determined separately, but the allocation would in each case be made by the formula method.

Footnote 40 which is referred to states:

> Shortly after the decisions of the California Supreme Court in Superior Oil and Honolulu Oil became final, Martin Huff, Executive Secretary of the Franchise Tax Board, arranged a conference attended by members of the staff of the Franchise Tax Board, representatives of the Attorney General's Office, representatives of the State Board of Equalization and representatives of the public who were intimately concerned with the Board's allocation policies. One of the authors of this article attended the conference and recommended the policy described in the text. It was recognized that in the case of most businesses doing business within and without the state there are elements of unity similar to those involved in the

Superior Oil and Honolulu Oil cases and relied upon by the court in upholding the formula method. It was further recognized that the above is true whether the businesses within and without the state are the same kind or a different kind. Nevertheless, because of the seriousness of the problem it was believed that if the formula method was to be extended to companies operating different kinds of businesses the extension should be made by the courts and the administrator should not assume responsibility for such a decision in the first instance.

More recently in "A Current Look at the Combined Report and Uniformity in Allocation Practices," 42 Journal of Taxation 106, 109 (1975), Mr. Keesling stated:

> The author early defined a unitary business as one in which there is a relationship of "dependency and contribution between the portions of the business within and without the taxing state." This was borrowed by the California Supreme Court in the Edison Stores case, and was later adopted by the California Franchise Tax Board, the successor to the California Franchise Tax Commissioner.
>
> At this point, it is questionable whether there is such a thing as a non-unitary business. Although it is appropriate to compute non-business income separately and to allocate it specifically, the view that all income from commonly-owned business activities should be combined and apportioned by a single formula without inquiring as to whether such activities are unitary or separate in nature seems preferable. Such a policy is simple to administer and will promote uniformity.
>
> Wherever there is common ownership there is a certain amount of common management, centralized performance of certain functions, and other indications of integration.

A policy which requires that the income from certain business activities should be computed and allocated separately on the grounds that such activities are not sufficiently integrated with other business activities to constitute a single unitary business will necessitate the drawing of numerous fine lines of distinction with respect to which reasonable people may well differ. Hence, any such policy will give rise to difficult administrative problems and will promote disparity rather than uniformity in allocation practices.

Moreover, such a policy works against the states and in favor of taxpayers. If a taxpayer wants the formula method to be applied across the board, it will call attention to various elements of integration and unity. If, however, it wants certain activities to be dealt with separately, such elements will be concealed and in many cases may not be discovered by state representatives.

Mr. Keesling went on to suggest that it might even be proper to treat all income as business income. See 1981 B. Y. U. L. Rev. 87, speculating on the results of *Mobil*, supra.

THE VIEWS OF CONTAINER CORPORATION OF AMERICA

CCA conducts its United States activities through a single corporation. No question has been raised regarding the fact that CCA is involved in a unitary business within the United States. CCA filed on this basis with California. It has never questioned this fact in subsequent proceedings.

THE FACT THAT A UNITARY BUSINESS IS CARRIED ON BY SEVERAL CORPORATIONS RATHER THAN A SINGLE ENTITY SHOULD NOT AFFECT THE RESULT

Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where the business is conducted by one corporation, the income is computed as a unit and apportioned by means of an appropriate formula.

• • •

When the combined report is employed, exactly the same procedure is followed, and the same results obtained, in cases where the business is conducted by more than one corporation. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only. (Keesling, Journal of Taxation, supra, p. 106.)

Keesling continues (p. 108) by describing the birth of combined reporting:

For many years following the inception of the California Franchise Tax in 1929, the members of a well-known, and, in those days, highly profitable, industry were paying only the minimum franchise tax. The technique was quite simple. The property produced in California was sold to wholly-owned out-of-state distributing corporations at cost. Thus, the production corporations in California filed returns showing no income from California sources. All of the income was reported by the distributing corporations, and for the most part escaped state income tax completely.

• • •

The thought occurred that if, in the case of a single corporation doing business within and without the taxing state, it is permissible for the state to look beyond its borders and take into account the entire income of the business in order to determine the true income realized from the portion of the business conducted within the state, then why should it not be equally permissible for a state, in the case of a multi-corporate business to look beyond the corporate lines and take into account the entire income from the business in order to determine the true income attributable to the corporation or corporations doing business within the state?

If in the case of a single corporation, the state is not compelled to make an apportionment on the basis of the taxpayer's books of account, but can disregard them and make the apportionment by applying a formula to the income from the entire business, then why shouldn't it likewise be permissible in the case of a multi-corporate business to disregard the taxpayer's books of account and apportion the income by applying a formula to the entire income of the business?

This line of reasoning appeared convincing, and so the combined return or combined report procedure was born. Its purpose was two-fold. First, to prevent tax avoidance through the manipulation of transactions, such as sales, between controlled corporations, and second, to insure that the income of a multi-corporate business should be computed and apportioned in the same manner as in the case of a single corporate business, thus promoting equality and uniformity in the application of the state's tax laws. It has accomplished both of these objectives very effectively.

The California Supreme Court in *Edison California Stores, Inc. v. McColgan,* 30 Cal. 2d 472, 183 Pac. 2d 16 (1947), sanctioned the combined report principle.

The *Edison* case involved a business based in St. Louis, Missouri, which had formed fifteen separate subsidiaries to operate shoe stores in fifteen different states. The California court found, "The business of the parent and all of its subsidiaries is owned and managed under one centralized system . . . [t]hus the business is unitary." (p. 480.) It further stated, "that the separate accounting method is appropriate to determine the true income of a separate business; but that when the business is not separate . . . separate accounting is inadequate and unsatisfactory." (pp. 480-481.) Clearly crucial to the Court's finding was the fact that the same type of business was operated in each state.

It is our understanding that Container Corporation of America (CCA) is involved in the manufacture of containerized packaging from the processing of raw materials such as wood pulp, waste paper, etc., into paperboard, the design of containers, including visual presentations, and the manufacture of paperboard into the final product. These processes are carried on throughout the United States by CCA. They are also carried on throughout significant portions of Latin America and Europe through subsidiaries. The same general activities are carried on in all jurisdictions. It logically and reasonably can be said that a single business exists encompassing all aspects of the manufacture and marketing of containers.

The Court should ask itself whether or not there is any material difference between how the United States business is operated and CCA's relationship with its for-

eign subsidiaries. If the relationship is the same, with perhaps some allowance for the distances involved, then the result should be the same.

Two differences are readily apparent. First, the activities are carried on in foreign countries; second, the activities are carried on by subsidiaries rather than by CCA. Should this make a difference? Clearly, it should not. And the Court has already so indicated.

With respect to the foreign character of the activities, the Court, in *Mobil Oil,* supra, said:

> Bass, Ratcliff & Gretton forecloses the contention that the foreign source of the . . . income alone suffices for this purpose. (p. 439.)

The Court went on to indicate that no effort was made to show the foreign activities were discrete in any business or economic sense. The effort has been made by CCA, but it clearly has failed, as shown by the second alleged distinction.

The Court should also ask itself, as it apparently did in *Mobil,* at 440-441, whether intercorporate division is relevant. The answer:

> Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability.
> (pp. 440-441.)

If the Court will but ask itself the same question with respect to CCA, the conclusion will be obvious.

The history of the development of the unitary method as set forth above shows that it is an evolutionary concept just as the decisions of this Court in the field of state taxation have been evolutionary. The unitary method originated with the effort by a single state to fairly apportion the property values of a single business, interconnected by tangible physical ties, amongst its subdivisions. The methodology was extended to cover property located in several states. It evolved to the point where no actual physical connection between the locations of the business was required. Then it was extended to income taxes in a case where the Court had previously suggested there was no connection. *Adams Express,* supra, compared to *Underwood Typewriter,* supra.

In the income tax field, the method was first applied to a vertically integrated business where manufacturing occurred in one state and sales in several states. Then it was extended to a horizontally integrated business where the same activities were conducted in several states under the overall control of a single management. It has evolved from situations involving direct physical ties between businesses to those involving intangible, but nonetheless real, ties. CCA represents a step along this progression. It should be viewed as representative of the current practice and not as a new extension. It involves nothing more than an enterprise engaged in the same type of business in a number of jurisdictions. These are not separate businesses but "branches" of the same business.

———o———

SUMMARY

Application of the principles set forth in the Multistate Tax Commission Regulations and as reflected in the decisions of this Court, the California courts, and one of the leading commentators in the field of state taxation, require this Court to sustain the determination of the California courts that CCA and its foreign subsidiaries are involved in a unitary business.

THE COURT'S RECENT DECISIONS IN ASARCO AND WOOLWORTH SHOULD NOT BE FOLLOWED IN THIS CASE

On June 29, 1982, this Court handed down decisions in *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*, — U.S. —, 50 Law Week 4957, and *ASARCO Inc. v. Idaho State Tax Commission*, — U.S. —, 50 Law Week 4962. In both decisions the Court held that dividends received by the taxpayers from subsidiaries and affiliates, all involved in the same general line of business as the dividend recipient, were not business income. We believe these cases were incorrectly decided. In any event, they are clearly distinguishable from the facts involved in this case and should not be followed in this case.

As set forth in the preceding sections of this brief, the majority opinions in both *ASARCO* and *Woolworth* appear to ignore presumptions arising from the fact that the entities involved in those cases were involved in a common business. Those presumptions provide a valid basis for finding that the unitary business principle is applicable. As Justice O'Connor said in her dissent in *ASARCO*, "Both common sense and business realities dic-

tate a different result." (Slip Opinion, p. 5.) This Court should grant rehearings in these cases and reverse its decisions.

Whether or not the Court chooses to reverse its unfortunate decisions in *ASARCO* and *Woolworth*, it is clear that there are two bases for distinguishing CCA. These distinctions dictate a different result in CCA.

First, the factual record developed in CCA establishes that a unitary relationship exists. A review of the findings of the California Court does not begin and end with the presumption arising from a similar business. There is no question of controlling ownership in CCA which was clearly a determinative factor in the Idaho Supreme Court's decision in *ASARCO,* and which the majority of this Court seemed to find relevant in its decision. The California Court's decision sets forth a number of relationships existing in CCA whose absence in *Woolworth* apparently controlled the outcome.

Second, CCA involves the use of the combination approach. Under this approach California has included all of the income, and more importantly all of the formula factors, in computing the amount of income properly attributable to California. CCA does not suffer from the potential defect raised by Justice Stevens in his dissent in *Mobil,* supra, at p. 460. The apportionment formula takes into account the income-producing activities which gave rise to the income. The formula assigns income

to California and it also would assign income to the foreign subsidiaries. This potential defect was not commented upon by the majority in *ASARCO* or *Woolworth*, but it must have entered into the decision-making process of at least one judge. The Court should take cognizance of the fact that it is not present in this case.

In the majority opinion in *ASARCO* the Court said the position advanced by the state would "destroy the concept"; in *Woolworth*, it "would trivialize the due process limitation." Justice O'Connor, in her dissent in *ASARCO*, says the majority "shrinks the concept beyond all recognition." It is clear that the Court is unanimous in its acceptance of the unitary business principle and that all members recognize the importance of maintaining its vitality. CCA involves an application of the unitary concept which provides the middle ground on which all members of the Court can agree. If the unitary concept is to remain vital, the Court must sustain the tax assessed by California.

CONCLUSION

This Court has the opportunity in CCA to reaffirm its support for the unitary business principle and clarify any misapprehensions which may have been created by its decisions in *ASARCO* and *Woolworth*. It should take

advantage of this opportunity and affirm California's action.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From the Court of Appeals
of the State of California

BRIEF OF THE STATE OF OREGON AS AMICUS CURIAE IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

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TABLE OF CONTENTS

Page

Statement of Interest of State of Oregon as Amicus Curiae 1

Summary of Argument 3

Argument 4

I. Worldwide formulary apportionment does not violate the Due Process Clause and does not produce extra-territorial taxation. There is no violation of the Commerce Clause because no multiple taxation of foreign source income can be proven. There are no enforceable uniform standards with respect to the states and this country and with respect to the international scene. Before an argument can be made that the federal government is prevented from speaking with one voice in regard to foreign policy, Congress must act 4

II. The *ASARCO* and *Woolworth* decisions indicate unrealistic and unreasonable due process standards for the utilization by the states of the unitary business principle in combining and apportioning of the net income of affiliated corporations 23

III. The facts in this case support the conclusion that Container is unitary with its foreign subsidiaries 30

TABLE OF AUTHORITIES

Table of Cases

Page

ASARCO, Inc. v. Idaho State Tax Commission, — U.S. —, 102 S. Ct. 3103, 73 L. Ed.2d 787, 50 U.S.L.W. 4962 (1982) ..... passim

Bass, Ratcliff & Gretton Ltd. v. State Tax Comm., 266 U.S. 271 (1924) 21

Butler Bros. v. McColgan, 315 U.S. 501, 62 S. Ct. 701 (1942), *aff'g.* 17 Cal.2d 664, 111 P.2d 334 ..... 5, 6, 26

Caterpillar Tractor Co. v. Dept. of Rev., 289 Or. 885, 618 P.2d 1261 (1980) 2

Chicago Bridge & Iron v. Caterpillar Tractor Co., 84 Ill.2d 102, 417 N.E.2d 1343 (1981) 2

Coca-Cola Co. v. Dept. of Rev., 271 Or 517, 533 P.2d 788 (1974) 2, 6, 8

Container Corp. v. Franchise Tax Bd., 173 Cal. Rptr. 121, 117 Cal. App.3d 988 (1981) 10

Donald M. Drake Co. v. Dept. of Rev., 263 Or. 26, 500 P.2d 1041 (1972) 2

TABLE OF AUTHORITIES—Continued

Table of Cases—Continued

Page

Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207 (1980) 11, 16, 26, 28

F. W. Woolworth Co. v. Taxation & Revenue Dept., — U.S. —, 102 S. Ct. 3128, 73 L. Ed.2d 819, 50 U.S.L.W. 4957 (1982) ..... passim

Humble Oil & Refining Co. v. Dept. of Rev., 4 O.T.R. 284 (1970) 11, 16

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) ..... passim

Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980) 22, 29

Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) 8, 10

Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) 19, 22

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) 6, 19, 24

Wisconsin v. J. C. Penney, 311 U.S. 435 (1940) 22

Zale-Salem, Inc. v. Tax Comm., 237 Or. 261, 391 P.2d 601 (1964) 2

Constitutional and Statutory Provisions

ORS 305.665 to 305.685 2

ORS 314.605 to 314.670 2

Art. I, § 32, Oregon Constitution 24

Art. IX, § 1, Oregon Constitution 24

Fourteenth Amendment, U.S. Constitution 24

Other Authorities

Altman & Keesling, *Allocation of Income and State Taxation* 107-108 (2d. ed. 1950) 7

Kesling "A Current Look at the Combined Report and Uniformity and Allocation Practices" 42 J. of Tax. 106 (February 1975) 8

G. J. Harley, *International Division of the Income Tax Base of Multinational Enterprise* (June 1980) 14

Comptroller General's "Report to the Chairman," House Committee on Ways and Means of the United States, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations" 14

TABLE OF AUTHORITIES—Continued

Other Authorities—Continued

	Page
H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18 (1962)	13
H.R. 10650, 87th Cong., 2d Sess. § 6 (1962)	13
"Development in Intercompany Pricing under § 482", Seventh Annual Institute on International Taxation 103 (1976)	14
"Multinational Corporations and Income Allocation under § 482 of the Internal Revenue Code", 89 Harv. L. Rev. 1202 (April 1976)	13
Internal Revenue Code (§482)	12, 13, 15, 24
Internal Revenue Code (§§ 901-907)	15
Internal Revenue Code, "Subpart F" (§§ 951 to 964)	15
"Recommendations of the Task Force on Foreign Source Income," § 28, Committee on Ways and Means, U.S. House of Representatives, March 8, 1977	25
United States-United Kingdon Treaty, Art. 9(4)	21

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On Appeal From the Court of Appeals
of the State of California

BRIEF OF THE STATE OF OREGON AS AMICUS CURIAE IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

STATEMENT OF INTEREST OF STATE OF OREGON AS AMICUS CURIAE

The State of Oregon, through its former State Tax Commission and present Department of Revenue has, since approximately 1955, applied the principles of formulary apportionment of the income of a corporation conducting a single unitary business. The state has applied principles of combined reporting and formulary apportionment of the income of a parent corporation and its subsidiaries likewise conducting a unitary multistate or multinational business. The state has established offices in New York, Chicago, San Francisco and Los Angeles to aid in the auditing of multistate and multinational corporations. In 1965

the state adopted the Uniform Division of Income for Tax Purposes Act (ORS 314.605 to 314.670). In 1967, it enacted the Multistate Tax Compact (ORS 305.655 to 305.685). Application of the unitary business principle and formulary apportionment has been upheld by the Oregon Supreme Court.[1]

Thus, the State of Oregon has an immediate and direct interest in this case as well as *Chicago Bridge & Iron v. Caterpillar Tractor Co.*, 84 Ill.2d 102, 417 N.E.2d 1343 (1981); oral argument in this Court April 19, 1982; reargument ordered by this Court May 3, 1982. (81-349). Oregon's raising and expenditure of revenue will be affected by the determination of the issues raised in this case and in *Chicago Bridge,* with regard to the constitutionality of nondomiciliary state taxation of worldwide combination.

In addition, after this case was decided by the lower court, the previously accepted methods of determining what constitutes a unitary operation for purposes of combined reporting have been put into question by the recent decisions of this Court in *ASARCO, Inc. v. Idaho State Tax Commission,* — U.S. —, 102 S. Ct. 3103, 73 L. Ed.2d 787, 50 U.S.L.W. 4962 (1982); and *F. W. Woolworth Co. v. Taxation & Revenue Dept.,* — U.S. —, 102 S. Ct. 3128, 73 L. Ed.2d 819, 50 U.S.L.W. 4957

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[1] *Coca-Cola Co. v. Dept. of Rev.*, 271 Or. 517, 533 P.2d 788 (1974); *Zale-Salem, Inc. v. Tax Comm.*, 237 Or. 261, 391 P.2d 601 (1964). *See,* also *Caterpillar Tractor Co. v. Dept. of Rev.*, 289 Or. 885, 618 P.2d 1261 (1980); *Donald M. Drake Co. v. Dept. of Rev.*, 263 Or. 26, 500 P.2d 1041 (1972).

(1982). These cases are being relied upon by Appellant Container Corp. [hereinafter "Container"] in this case. Oregon has a vital interest in the applicability and correctness of the standards announced in these cases.[2]

SUMMARY OF ARGUMENT

At stake in this case is a state's authority to use the only reasonable and economically feasible method for determining the portion of a corporation's net income that is attributable to the activities of the corporation in the state, where the corporation is a part of an affiliated group engaged in a unitary business. Oregon supports the following propositions:

1. Combination and apportionment on worldwide basis is constitutional and does not violate either the Commerce Clause or the Due Process Clause. There is no extraterritorial taxation or multiple taxation of foreign source income through the use of combined reporting. Until Congress acts to prohibit the states from utilizing the unitary principle and each foreign country acts with respect to political subdivisions or entities within its territories, there can be no violation of the Commerce Clause.

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[2]Thus, even if this Court should grant Idaho's and New Mexico's petition for rehearing and redetermine the due process standard for including dividends and other intangible income of a subsidiary in the apportionable income tax base of a parent to accord with the "business purpose" test advanced by the states, the *ASARCO* and *Woolworth* decisions need re-examination in light of the Court's basic determination of what constitutes the test of a unitary business for purposes of combined reporting and formulary apportionment.

2. The *ASARCO* and *Woolworth* decisions, if correctly understood, indicate unrealistic and unreasonable due process standards for the utilization by the states of the unitary business principle in combining and apportioning the net income of affiliated corporations. If applied to this case, clarification of the Court's language is needed.

3. The facts in this case support the conclusion that Container is unitary with its foreign subsidiaries, unless a prohibitive standard is erected on the basis of this Court's recent decisions in *ASARCO* and *Woolworth*.

ARGUMENT

I

WORLDWIDE FORMULARY APPORTIONMENT DOES NOT VIOLATE THE DUE PROCESS CLAUSE AND DOES NOT PRODUCE EXTRATERRITORIAL TAXATION. THERE IS NO VIOLATION OF THE COMMERCE CLAUSE BECAUSE NO MULTIPLE TAXATION OF FOREIGN SOURCE INCOME CAN BE PROVEN. THERE ARE NO ENFORCEABLE UNIFORM STANDARDS WITH RESPECT TO THE STATES AND THIS COUNTRY AND WITH RESPECT TO THE INTERNATIONAL SCENE. BEFORE AN ARGUMENT CAN BE MADE THAT THE FEDERAL GOVERNMENT IS PREVENTED FROM SPEAKING WITH ONE VOICE IN REGARD TO FOREIGN POLICY, CONGRESS MUST ACT.

A. There is no extraterritorial taxation. Container cannot pick out certain factors based upon separate accounting principles as showing extraterritorial taxation.

In considering whether there can be any extraterritorial taxation of income earned in foreign countries, Container uses separate accounting to support its arguments that the foreign subsidiaries operated at a substantially higher rate of profitability than Container. The arguments are that there are lower wage rates in foreign operations and that Container's net income as a percentage of sales or a percentage of invested capital is less than that attributable to foreign operations. Container's arguments have no validity whatsoever if, in fact, Container and its foreign subsidiaries are operating a unitary business. As stated by this Court in *Butler Bros. v. McColgan,* 315 U.S. 501, 62 S. Ct. 701 (1942), *aff'g.* 17 Cal.2d 664, 111 P.2d 334, at page 507:

> "It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. Sanders, Hatfield & Moore, A Statement of Accounting Principles (1938), p. 26. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a

> State seeks to tax values created by a business within its borders. * * *"

If this Court finds that Container and its foreign subsidiaries are truly operating a unitary business, neither this Court nor California need attack the integrity of Container's accounting evidence.

When a group of affiliated corporations is truly operating a unitary business, the several states face "the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Butler Bros. v. McColgan, supra* at page 507, quoting Mr. Justice Brandeis in *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113, 121 (1920). In *Coca-Cola Co. v. Dept. of Rev.,* 271 Or. 517, 533 P.2d 788 (1974), the Oregon Supreme Court quoted from the California Supreme Court decision, affirmed by this Court in *Butler Bros. v. McColgan, supra,* to the effect that:

> "'* * * It is only if its business within this state is truely separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer [citing authorities].' 17 Cal.2d 667-678." 271 Or. at 523, 533 P.2d at 791.

Thus, if this Court determines that Container and its foreign subsidiaries are a truly unitary business, it

may disregard any evidence as to differences in profitability or wage rates.

One may appropriately ask why it is that a United States company would expect to receive a greater rate of return on a foreign investment than on a similar domestic investment. (App. Br. 14) Container does not say that it is exclusively due to lower labor costs. Container states at page 14 of its brief that "the reasons for this *include* lower labor costs, more rapidly expanding economies, greater market share, governmental protection from compliance, *etc.*" Therein lies the rub. It was recognized early in the development of the theory of apportionment formulas that:

> "* * * Business income is generally attributable to a great number of factors or activities, the relative importance of which may vary greatly in different businesses. Any attempt to determine precisely the factors and activities responsible for the earning of income and their relative weight, even in the case of a single business, is certain to encounter serious difficulties. To make such a determination in the case of all taxpayers subject to any particular state's taxing law is utterly out of the question as a practical administrative matter. Thus, in this field, as in many other fields, the ideal cannot be obtained. Something less than perfection must suffice." Altman & Keesling, *Allocation of Income and State Taxation* 107-108 (2d. ed 1950).

For these reasons, this Court has said on many occasions that an apportionment formula — even a formula utilizing a single factor — is "employed as a rough

approximation of a corporation's income that is reasonably related to the activities conducted within a taxing State." *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 273 (1978).

A successful domestic corporation setting up a new business in a foreign country considers whether the new business should operate as a branch or division or as a separate legal entity. This decision may depend upon the federal tax laws and the advantages and opportunities contained in its provisions. But the method of operation, as a single corporation or as separate entities, should not determine the state tax consequences.[3]

See Keesling, "A Current Look at the Combined Report and Uniformity and Allocation Practices," 42 J. of Tax. 106, 107 (February 1975). Before this Court could accept evidence based upon separate accounting systems determined and tailored to the corporation's own needs, as conclusively showing the importation of extraterritorial income from overseas to California, other offsetting factors contributing to the earning of net income must be examined in some detail.

Container therefore, should be asked, for example, what intangible values it exported to the foreign subsidiaries when it created the new businesses in foreign

[3] As succinctly stated in *Coca-Cola v. Dept. of Rev., supra* 271 Or. at 528:

"The question is fundamentally one of whether a business should stand in a better position for purposes of determining income merely because it chooses to use a multiple corporation organizational scheme. We do not feel that it should. * * *"

countries. Were the plants and machinery and equipment utilized overseas selected, purchased, set up and put into operation independently of any supervision, advice, or credit guarantees of the parent company? Were the manufacturing processes employed developed solely and exclusively by the foreign subsidiary and its personnel, or did parent know-how contribute to the adoption of such processes? Did the experience of highly parent technicians, and the top management of Container have anything to do with the profitability expectation and realization? Did the careful selection of local personnel and local management by the parent company have anything to do with the profitability? Did the existence of a relationship between Container, the parent, and the foreign subsidiary, play a part in the business dealings between the foreign subsidiary and its creditors, customers or others?

An incongruity is created by the representation in Container's statement of the case (App. Br. 44-45) that major policy matters were the responsibility of the foreign subsidiaries but were generally subject to review by Container. If major policy matters were generally reviewed by Container, it must follow that they were the responsibility of Container.

An incongruity is created by Container's statement (App. Br. 5) that each subsidiary had total responsibility for its own performance, yet was overseen by Container's foreign operations staff. How many critic-

al and significant decisions about the proper management and profitability of any one subsidiary in any one year were made by the two full-time operations officers and the senior executive officer, comptroller and lawyer during the course of each tax year in question?

Some of these questions are answered by the evidence. Some might be answered if the case is remanded for further evidence. Some may never be answered. The use of the unitary business principle and formulary apportionment obviates the need to answer all of the questions raised above.[4]

The evidence presented by Container does not show by clear and convincing evidence that there was a distortion of apportionment result and that extraterritorial values were imported to this country. Container should not be permitted to pick out income-contributing factors favorable to itself, based on separate accounting principles. Net income does not have a single identifiable source. *Container Corp. v. Franchise Tax Bd.*, 173 Cal. Rptr. 121, 132, 117 Cal. App.3d 988 (1981). The three factors of property, payroll and sales must "represent" all income earning factors, including "contributions to income which result from

[4]If California had used a constitutionally acceptable single factor formula based only on sales (the method sustained by this Court in *Moorman, supra*), what significance would there be in the wage differential between the foreign subsidiaries and the United States, or as a matter of fact, any wage differential within this country?

the functional integration and centralization which exist in a unitary operation." *Id.*, 132.

B. California's apportionment of income on a worldwide, combined basis does not result in taxation of income also taxed by foreign countries. There is no violation of the Commerce Clause.

Container's argument, that worldwide apportionment results in taxation of income also taxed by foreign countries, is completely dependent upon the use of separate accounting systems adopted by the federal government and separate accounting systems utilized by foreign countries in which Container's subsidiaries operate. Container's brief leaves the impression that something more than the income attributable to Container's activities in California is being determined. In order to disprove the correctness of California's apportionment formula method, the Court is asked to assume that separate accounting and the figures presented in the record by Container as to amounts of income attributable to various countries and to this country are above question and correct.

In *Exxon Corp. v. Wisconsin Dept. of Rev.*, 447 U.S. 207 (1980), Exxon's separate accounting showed no profit from Exxon's Wisconsin marketing operation. Oregon has had the same experience. In *Humble Oil & Refining Co. v. Dept. of Rev.*, 4 O.T.R. 284 (1970) the separate books of account maintained by Humble for the Oregon operations showed a net operating loss.

Application of formulary apportionment on the unitary basis showed a profit in both *Exxon* and *Humble*.

Separate accounting does not fairly determine the amount of income attributable to activities in a taxing state. Separate accounting is more likely to result in misattribution than formulary apportionment. On page 17 of Container's brief, separate accounting attributes $1,286,000 of income to Panama, even though the company had no property, payroll or sales in that country. There is no reason to believe that the United States Treasury was not shorted the taxation of $2,407,000 in 1963, $3,996,000 in 1964 and $5,466,000 in 1965 (App. Br. 16) because Container used separate accounting in reporting to the Internal Revenue Service. Container claims an average pretax income throughout the world for the tax years in question of $41,710,000 (App. Br. 17). For 1963, the increase in income attributable to California under its worldwide combination method was 6/10 of one percent of the worldwide income; for 1964 was one percent of worldwide income and for 1965 was 1.38 percent. This is hardly a staggering change.

The United States itself does not accept separate accounting for tax purposes at face value. Section 482 of the Internal Revenue Code provides for adjustments to prevent improper shifting of income by multinational corporations. In 1962 the United States House

of Representatives passed a version of the Revenue Act of 1962 that contained specific authorization to use a unitary method and apportionment with respect to foreign affiliates.[5] The Conference Committee determined that there was sufficient authority under I.R.C. § 482, which includes the words "apportion" or "allocate",[6] to accomplish the same result by regulation.[7]

The ineffectiveness of § 482 methods has been recognized. See "Multinational Corporations and Income Allocation under § 482 of the Internal Revenue Code", 89 Harv. L. Rev. 1202 (April 1976). This article concludes, at page 1238:

> "The use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the surprisingly frequent reliance of revenue agents and courts on ad hoc fourth method approaches, based not on the theory of the regulation, but on the unitary entity theory. While the unitary entity theory itself is not free from difficulty, it has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to

[5] H.R. 10650, 87th Cong., 2d Sess. § 6 (1962).

[6] "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or nor affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." (§ 482, IRC).

[7] H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18 (1962). A new regulation was promulgated which expanded upon the arm's length standard. See discussion in 89 Harv. L. Rev. 1202, 1212, cited in text, *infra*.

> current practice. At least in a short run, such consideration may take the form of its adoption as an optional safe-haven rule."

See, also, "Development in Intercompany Pricing under § 482", Seventh Annual Institute on International Taxation 103 (July 16, 1976); and G. J. Harley, *International Division of the Income Tax Base of Multinational Enterprise* (June 1980) (a treatise submitted for the degree of Doctor of the Science of Law at the University of Michigan Law School and published by the Multistate Tax Commission, Boulder, Colorado).[8]

The Comptroller General's "Report to the Chairman," House Committee on Ways and Means of the United States, entitled "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations", constitutes an indictment of the § 482 separate accounting method utilized by the Internal Revenue Service. This study, as well as the Harvard Law Review article and the Harley treatise referred to above, demonstrate that Container cannot reasonably represent to this Court that the arm's length method of reporting income results in an accurate determination for either the United States or any

[8]Mr. Harley's thesis is that the unitary method is theoretically superior to arm's length transactional analysis and is suitable for international adoption by the world's trading nations, acting in concert through a common, centralized, international administrative agency. Such adoption would simplify the Internal Revenue Code and its regulations, eliminate most of the present double taxation issues between nations, simplify tax treaty structures and encourage developing countries to join an international tax treaty structure.

of the foreign countries. There is no way for this Court to determine whether the figures presented by Container accurately attribute its domestic and foreign income to the United States and to other nations. Nor is there any way of determining whether the amount apportioned to California under the unitary theory, together with other amounts reported to the other several states, overstate or understate its domestic income. Conceivably, the total amount reported to the 50 states by Container does not constitute full accountability of its domestic income even under its reporting methods. In other words, if Container alleges that $28,121,000 is taxable as United States income, how do taxing officials and this Court know that this has been reported to the several states and that California has more than its proper share?

Any possibility of double taxation is alleviated not only by I.R.C. § 482, to the extent it effectively reallocates income, but by other provisions of the Internal Revenue Code, such as "Subpart F" (I.R.C. §§951 to 964) and the foreign tax credit (I.R.C. §§ 901-907). The foreign tax credit equalizes the tax burden between domestic corporations and corporations operating both domestically and overseas. The United States does not control the tax policies of the foreign country. Both countries have jurisdiction to tax the income. Therefore, in the absence of some accommodation by the foreign country, the United States, by unilaterally

permitting a foreign tax credit on foreign source income against the amount of the United States tax guarantees parity of treatment.

In summary, this Court should not conclude that the evidence and assertions of Container clearly and convincingly show that (1) Container and its subsidiaries have fully accounted for all of their taxable income to all foreign countries and to this country; (2) the distribution by separate accounting formula is proper as between the United States and foreign countries; and (3) the amount attributable to the corporation's activities in California through formulary apportionment, which is in excess of the amount attributable through separate accounting, is double taxation. It may not be reported anywhere. It may be income that should be reported to California because the separate accounting systems, as illustrated by the *Exxon* and *Humble* cases, *supra,* attribute income the way the corporation wants. Separate acco[illegible]g, in essence, is a corporate determination of where it thinks the profits should lie and nothing else.

C. California's use of unitary worldwide combined reporting does not prevent the federal government from speaking with one voice in regard to foreign policy, thereby violating the Commerce Clause.

Container's argument is based upon the erroneous assumption that the separate accounting method cor-

rectly attributes income to the various foreign countries and to the United States in such a way that any different system constitutes a system of double taxation. Container basically relies upon *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979). The decision in that case hinged on the fact that "all appellants' containers are subject to property tax in Japan and, in fact, are taxed there" (*Id.* at 452). A similar fact situation is an absolute prerequisite to any parallel holding in the income tax field. The Court cannot find a violation of the Commerce Clause unless Container has made a satisfactory showing that Container and its subsidiaries have fully accounted for all their taxable income, both domestically and in all foreign countries in which they do business, and that no part of the net income attributed to foreign subsidiaries in fact constituted the domestic net income of Container Corporation. In *Japan Line,* there was no question that the instrumentality in foreign commerce was fully taxed by Japan. It was so stipulated. In the instant case, the state is dealing with a domestic corporation which has attempted to disassociate its foreign activities by the device of foreign subsidiaries. California is attempting to determine the portion of the net income of Container Corporation that is attributable to Container's activities within the state. The attribution of net income under separate accounting can shift back and forth as various methods are

used under I.R.C. § 482 to reallocate income and expense items between related corporations.

The concept of what is "net taxable income" is abstract in nature. The final sale of the product is the ultimate realization of net taxable income. Until that time it is impossible to determine whether income is earned. For example, income taxation of a vertically integrated metals operation involves the question whether the income is "earned" by the mining operation, the smelting operation, the refining operation, the creation of the finished product (such as a pot or pan) or the efforts of the sales organization, to name only a few factors contributing to the earning of that net income. The question is different from an issue of the physical location of a container making its way from its home port in Japan to various ports around the United States and the world.

Container has not alleged, nor could it assert, that there is some internationally accepted administration of the arm's length standard. There is no international body to enforce the uniform arm's length standard among all nations and their political subdivisions, notwithstanding the existence of numerous treaties. The situation in this case would be analogous to the posture of *Japan Line* only if an international standard of separate accounting were a part of the law of every nation and the standard were uniformly administered by an international staff making adjust-

ments on behalf of nations competing for the same taxable net income, subject to the jurisdiction of an international tribunal recognized by all nations. In *Japan Line,* this Court could be certain that the container was fully taxed by Japan. In this case, there can be no certainty, under the separate and independently administered income tax systems of the many nations and their political subdivisions, that all income is reported, that the same standards of determining net income are followed, or, in short, that there is any double taxation.

This Court determined in the *Japan Line* case that when a state seeks to tax the instrumentalities of foreign commerce, two additional considerations come into play: First, the enhanced possibility of multiple taxation; and, second, that a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. The tax that California seeks to impose is "levied only on that portion of the taxpayer's net income which arises from its activities within the taxing state." *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 464 (1959).

To repeat, income does not have a single identifiable source. The question is the same as considered by this Court in *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920), cited with approval in *Northwestern States Portland Cement Co. v. Minneso-*

ta, supra. In the *Underwood* case the Court described the dilemma facing the state:

> "* * * The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with the sale in other states. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the *impossibility of allocating specifically* the profits earned by the processes conducted within its borders. It therefore adopted a method of apportionment *which, for all that appears in this record, reached and was meant to reach, only the profits earned within the state."* 254 U.S. 120-121. (Emphasis added)

This dilemma is compounded by the fact that Container operates through foreign subsidiaries. California or any other state using formulary apportionment is not "sourcing" to the state income earned in a foreign jurisdiction by a foreign subsidiary.

The first test of *Japan Line* is whether there is a substantial risk of multiple taxation. Because Container cannot show that separate accounting accurately accounts for all of its taxable income and may result in underreporting, the first test of *Japan Line* cannot be met.

The second test of impairment of federal uniformity is not implicated here. In the *Japan Line* case, California and other states had imposed property taxes on Japanese-owned containers as they moved

through the states in international commerce. The national policy, expressed in a Custom Convention on Containers, was to remove barriers to the use of containers in international traffic. The Court found that the state taxation of the Japanese containers constituted "an asymmetry in international maritime taxation operating to Japan's disadvantage." 441 U.S. at 453.

No such asymmetry can be found here. Congress has not acted to preclude the states from employing an *accounting method* to determine the amount of net income attributable to activities within a particular state. The use of an accounting method in a situation where net income cannot be sourced, as containers can be, creates no impediment or interference with the United States acting as it has, in adopting separate accounting for federal purposes in agreement with the adoption by foreign countries of separate accounting. Indeed, Congress rejected the only attempt made to date to include a specific prohibition in a treaty against the states' use of combined reporting. That was the rejection of Art. 9(4) by Congress of that provision in the United States-United Kingdom Treaty, in 1977.[8]

Notwithstanding Container's assertions that this Court's decision in *Bass, Ratcliff & Gretton Ltd. v.*

[8]Convention between the Government of the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation. Signed at London December 3, 1975; entered into force April 25, 1980.

State Tax Comm., 266 U.S. 271 (1924) (App. Br. fn. 2) is out of date, that case still represents this Court's recognition (as in *Wisconsin v. J. C. Penney,* 311 U.S. 435 (1940)), and *Northwestern States Portland Cement Co. v. Minnesota, supra,* that the nature of the problem of determining net income attributable to sources within a state does not impede or touch upon interstate or international commerce. An accounting method does not increase or decrease the flow of international trade. It neither affects the enforceability of tax treaties between the United States and other nations, nor violates any prohibition contained in any treaty or law enacted by the United States Congress. It cannot be shown that the income "attributed" to California is anything but part of the domestic income reported by Container to the United States Treasury, and certainly it cannot be shown that the income constitutes a part of any foreign source income.

Because *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980) did not answer serious questions about the taxability of dividends by various states, the true question in this case might be whether the method used by California and 12 other states (App. Br. 34) is in conflict with other methods utilized by other states, in attributing Container's domestic income to the states in which it does business in this country. Domestic taxation may be the only real issue here. Container has not shown that the income attrib-

uted by California to Container's activities in California has a foreign source. There is no actual multiple taxation, and problems of multiple taxation at the international level are not germane in this case. The concurrent federal and state taxation of income is a well-established norm. If the United States Government is fearful of California and other states' attempts to obtain information for purposes of applying the unitary business principle and formulary apportionment, it may speak with one voice through Congress. The employment of an accounting method and the request for information to effectuate that method is not frustration of international tax policy nor prohibition of the United States' enforcement of that policy at the international level.

II

THE *ASARCO* AND *WOOLWORTH* DECISIONS INDICATE UNREALISTIC AND UNREASONABLE DUE PROCESS STANDARDS FOR THE UTILIZATION BY THE STATES OF THE UNITARY BUSINESS PRINCIPLE IN COMBINING AND APPORTIONING OF THE NET INCOME OF AFFILIATED CORPORATIONS.

Even if this Court should reverse *ASARCO* and *Woolworth* on rehearing with respect to the due process determinations on the inclusion of dividends and other intangible income in the apportionable income tax base, there remains for the states the barriers of the Court's language with respect to the unitary business principle as applied to affiliated corporations.

The applications of these decisions to the outcome of this case are not clear.

In dealing with the problem of attributing net income to the activities of a multinational corporation affiliated either with domestic or foreign corporations or both, state administrators are in a different position than the federal government. Oregon and other states may not operate at a deficit. States are faced with the necessity of treating taxpayers uniformly, whether it be due to application of the Fourteenth Amendment to the United States Constitution or state constitutional provisions such as Art. I, § 32 and Art. IX, § 1 of the Oregon Constitution. The federal tax system is based upon the residency theory of taxation. A state may not tax a corporation upon all of its net income, as it may tax individuals. In *Underwood Typewriter v. Chamberlain, supra,* this Court recognized that the states are "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders," and that the method of apportionment is meant to reach "only the profits earned within the state." 254 U.S. at 121. This is the problem California faced in attempting to determine the taxable income of Container.

The inadequacies of I.R.C. § 482 adjustments based upon a "true" arm's length pricing system are notorious. The United States Congress Committee on Ways and Means has recognized that § 482 type adjustments

will not work for the states and that the states must utilize formulary apportionment. Section 28 of "Recommendations of the Task Force on Foreign Source Income," Committee on Ways and Means, U.S. House of Representatives, March 8, 1977, states in part that:

> "* * * There is no significant disagreement that States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States."

Taxation is a practical matter. If the Due Process Clause, as interpreted by this Court, prohibits utilization of the unitary business principle and formulary apportionment, non-uniformity of taxation must follow. Consequently, a substantial share of the tax burden must be shifted from the multistate and multinational corporations to domestic corporations and individuals within the taxing state. The due process requirements announced in the *ASARCO* and *Woolworth* cases may constitute standards which the states cannot meet with any reasonable personal resources and of auditing procedures.

Two areas are of particular concern: (1) What does this Court mean by "potential to operate a company as a part of a unitary business" and "actual control"; and

(2) what must be the relationship of the subsidiary's activities to the activities in the taxing state?

1. *"Potential" as contrasted with "actual" control.* The court in *F. W. Woolworth Co. v. Taxation and Revenue Dept., supra,* (slip op. at 7) states:

> Our decision in ASARCO makes clear, however, that the *potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the underlying economic realities of a unitary business,' the dividend income from the subsidiaries *in fact* is derive[d] from 'unrelated business activities' which constitutes a 'discrete business enterprise.' ". (Referring to ASARCO and its subsidiary M.I.M. in which ASARCO owned 52.7 percent of the stock.)

This Court then turns to the discussion of functional integration, centralization of management, and economies of scale. The Court refers to *Butler Bros. v. McColgan, supra,* 315 U.S. at 508-509. *Butler Bros.,* is a decision involving only a single domestic corporation. The *Woolworth* decision also relies heavily upon this Court's decision in *Exxon, supra,* another case involving only a single domestic corporation.

The "underlying economic realities" in the case of a domestic parent and foreign subsidiaries are entirely different. It is possible that, in a worldwide operation where a product may not flow from overseas to this country, the market place in a particular country may be serviced by local production or by an exchange agreement such as was found in *Exxon.* In the instant

case, practical economic realities would dictate that purchase of wholesale goods for resale to final customers would take place at the market place closest to the retail operation, due to the economies of transportation and the tastes and habits of the local consumers. These factors do not foreclose characterization of the operation as unitary. This question could be supervised by one or two officers of the parent company, and adequate controls could be maintained by the usual and ordinary lines of communication and financial reporting made by a subsidiary to its parent.

There might be good reasons by Woolworth, for example, would not engage in a centralized purchasing, warehousing and merchandise operation encompassing such far flung operations as Germany and Mexico. However, economies of scale with respect to the market place in a particular country could still obtain, and final decision making and approval could come from the parent's place of business. Such appears to be the case with Container. This is the economic reality.

With respect to the utilization of separate corporations rather than divisions in one company, common sense and economic realities dictate that, especially with a foreign country, foreign personnel be utilized as much as possible. As in the case of Container, it made political sense to have local operations conducted by efficient and well trained local personnel. An efficient

parent could still maintain control of its subsidiaries. Regulation of its own day-to-day activities by a subsidiary is not the exception; it is the rule. Where distance, language differences and diverse markets intervene, there are going to be different methods of operation and management. But this does not mean that the parent corporation is not exercising control and that it is not a unitary operation.

The question is how a state may apply the test in *Exxon,* 447 U.S. at 207, on a worldwide basis where a state must prove:

> "* * * long-range planning for the company, maximization of overall company operations, development of financial policy and procedures, financing of corporate activities, maintenance of the accounting system, legal advice, public relations, labor relations, purchase and sales of raw * * * materials and coordination between * * * operating functions. * * *"

To do this on an year-to-year basis, with regard to the parent and each of its subsidiaries, the state will have to have its auditors examine the affairs of each corporation on a day-to-day basis, read corporate and committee minutes of the corporation, inquire about telephone calls, and otherwise gather the intimate indicators of control. It is no secret that control may be effectively maintained by several persons through selection of like-minded subordinates, directed through telephone communications and internal memoranda. American business has numerous

examples of "one man" operations. Certainly a small staff in the office of Container could control the activities of foreign subsidiaries for all practical purposes.

2. *Relationship of the activities of the foreign corporation to activities within the taxing state.*

This Court should explain that its language in the *ASARCO* and *Woolworth* cases requires only a "rational relationship", in the sense that the activities in the taxing state and the activities of the subsidiary are links in a common chain even though the chain has several links. In a unitary business, such as a vertically integrated operation, mining in one state is, in turn, connected to a smelting operation in another state, a refining operation in a third state, a manufacturing operation in a fourth state, and a sales organization in a fifth state from which the final product is marketed in 50 states and in several foreign countries. This Court's statement in *Mobil,* 445 U.S. at 441-442, about business activities of a foreign subsidiary having "nothing to do with the activities of the * * * taxing state", cannot mean that the states have a due process burden of showing that the mining activities on a day-to-day basis are connected to the sales operation, other than as a part of the "chain of events" running through the vertically integrated operation.

In considering this case, the Court should distinguish clearly *ASARCO* and *Woolworth* and set its due

process standard no higher than necessary to recognize the true, economical realities of international corporate operations. The Court should consider that intangible methods of control may defy discovery unless a state audit department resorts to unreasonable audit time and unrealistic staff requirements, which have the potential to harass the taxpayer.

III

THE FACTS IN THIS CASE SUPPORT THE CONCLUSION THAT CONTAINER IS UNITARY WITH ITS FOREIGN SUBSIDIARIES.

The brief of Appellee Franchise Tax Board adequately presents the factual situation presented here. Amicus believes that the lower court's opinion correctly analyzed the factual situation. Barring establishment of a prohibitive standard based upon language in *ASARCO* and *Woolworth,* this Court should find that the state sufficiently demonstrated that Container conducted a unitary operation. The judgment of the lower court should be affirmed.

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CONTAINER CORPORATION OF AMERICA, *Appellant*,

vs.

FRANCHISE TAX BOARD, *Appellee*.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

BRIEF OF PHILLIPS PETROLEUM COMPANY AS AMICUS CURIAE IN SUPPORT OF APPELLANT

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TABLE OF CONTENTS

Statement of Interest 1

Summary of Argument 3

Argument—

I. The Worldwide Combined Method of Apportioning Income Is Inherently Arbitrary and Grossly Distorts Worldwide Income and Results in Multiple Taxation of Worldwide Income, in Violation of the Due Process Clause of the United States Constitution 4

II. The Worldwide Combined Method of Apportioning Income Is Unconstitutional Under the Commerce Clause of the United States Constitution 8

Conclusion 11

TABLE OF AUTHORITIES

Cases

Evco v. Jones, 409 U.S. 91 (1972) 9

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 8, 9, 10

J. D. Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938) 9

Norfolk & Western Railway Co. v. Missouri State Tax Commission, 390 U.S. 317 (1968) 8

Zschernig v. Milier, 389 U.S. 429 (1968) 10

United States Constitution

Foreign Commerce Clause

Article I, Section 8, Clause 3 ..... 2, 4, 7, 9, 10

Due Process Clause

Amendment XIV, Section 1 ..... 2, 3-4, 7, 8

United States Code

Allocation of Income and Deductions Among Taxpayers - 26 U.S.C. § 482 4

Income From Sources Without the United States Foreign Tax Credit - 26 U.S.C. § 901 6

Code of Federal Regulations

Allocation of Income and Deductions Among Taxpayers - 26 C.F.R. § 1.482 5

Other Authorities

2 CCH Tax Treaties ¶¶ 6053, *et seq.* - Income Tax Treaty Between Norway and the United States 5, 6, 10

Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations, 95th Cong., 1st sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury) 5

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BRIEF OF PHILLIPS PETROLEUM COMPANY AS AMICUS CURIAE IN SUPPORT OF APPELLANT

STATEMENT OF INTEREST

The written consents of Appellant and Appellee are on file with the Clerk of this Court.

Phillips Petroleum Company and its subsidiaries (Phillips) are engaged in petroleum exploration and production and chemical production and sales on a worldwide basis. A substantial portion of Phillips' income is generated in Norway, due to its business activities there.

The effects of the method of state taxation as presented in this case are of vital concern to Phillips, as it is currently contesting the application of this method in several states at the administrative level.

100% of that portion of Phillips' worldwide income that is earned in Norway, as well as most other jurisdictions outside the United States (foreign) is subjected to income tax by those foreign jurisdictions by means of the arm's-length method of determination.

Under the arm's-length method, the income of each business entity is determined, based on generally accepted accounting principles, as if that entity's business was conducted by an independent entity and 100% of that entity's income is subjected to tax by the country in which the entity operates, without reference to income of any affiliated entity.

On the other hand, California and several other states within the U.S., for the purpose of state taxation, use the worldwide combined method of apportioning income. That method requires that Phillips' worldwide income be apportioned to those states by use of a three-factor formula consisting of property, payroll, and sales.

No adjustments (such as deductions or credits for income tax paid to other jurisdictions) are made by California to recognize the effect of the taxing methods employed by the other jurisdictions.

The result of the simultaneous application of these two inconsistent methods to a taxpayer's worldwide income results in multiple taxation of that worldwide income, contrary to the Due Process and Commerce Clauses of the United States Constitution.

Through this Brief, Phillips hopes to alert the Court to the inherent improprieties and inequities in the California method of taxation as applied to taxpayers such as Phillips and their income earned from foreign operations in Norway and other countries where similar conditions prevail.

SUMMARY OF ARGUMENT

As applied by California and other states having similar taxing methods, the worldwide combined method of apportioning income is inherently arbitrary. It grossly distorts the determination of worldwide income, relative to its sources and constitutes oppressive multiple taxation when applied unilaterally by a state taxing jurisdiction, when the arm's-length method is simultaneously applied by foreign jurisdictions.

On the one hand, Phillips is required, by treaty in many instances, such as Norway, to report its income to foreign governments utilizing the arm's-length method of determination of income and, on the other hand, to report its income to a state, such as California, utilizing the worldwide combined method of apportioning income.

Most foreign taxing jurisdictions use the arm's-length method of determining income, which subjects 100% of a taxpayer's income earned in that jurisdiction to its income tax. The use by California and other states of the worldwide combined method of apportionment is inconsistent with the arm's-length method, because the worldwide combined method includes for apportionment income already subjected to tax by one or more other jurisdictions under the arm's-length method. Since the worldwide combined method includes income from foreign jurisdictions which, by virtue of use of the arm's-length method of determining income, will be or have been already taxed, in the foreign jurisdiction, the inevitable result of the use of the worldwide combined method, by California or any other state, is a gross distortion and misallocation of worldwide income. Thus, the worldwide combined method arbitrarily and unreasonably attributes extraterritorial income to California, contrary to the Due

Process Clause of the United States Constitution. This necessarily results in multiple taxation by such states, contrary to the Commerce Clause of the United States Constitution.

In a purely domestic context, this Court can prevent these unconstitutional results when inconsistent income apportionment methods are employed by different states within the United States, because the state taxing authorities are all under its jurisdictional powers. In an international context, however, no tribunal exists which has jurisdictional powers over all of the taxing authorities. Taxpayers under the taxing jurisdiction of both this nation and foreign sovereigns are subjected to and at the mercy of the various and diverse taxing methods around the world.

Avoidance of the unconscionable results of the California worldwide method of apportionment can only be assured by disallowing that method as inherently defective.

ARGUMENT

I

The Worldwide Combined Method of Apportioning Income Is Inherently Arbitrary and Grossly Distorts Worldwide Income and Results in Multiple Taxation of Worldwide Income, in Violation of the Due Process Clause of the United States Constitution

The arm's-length standard for determining income among related domestic and foreign corporations has been adopted by the Internal Revenue Service in administering the Federal tax laws. The regulations implementing Internal Revenue Code § 482 (26 United States Code § 482) evidence this fact:

> (b) *Scope and Purpose.* The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. * * *[1]

True taxable income is defined to mean:

> (6) * * *, in the case of a controlled taxpayer, the taxable income * * * which would have resulted to the controlled taxpayer, had it in the conduct of its affairs * * * dealt with the other member or members of the group at arm's-length * * *.[2]

This method of determination has been accepted on a wide international scale.[3]

The U.S./Norway tax treaty, signed December 3, 1971, and brought into force November 29, 1972, was entered into for the express purpose of "* * * the avoidance of double taxation * * * with respect to taxes on income * * *."[4] This treaty is an effort to guarantee that the income determined taxable by use of the arm's-length method by one jurisdiction is not again subjected to taxation by the other. The treaty provides that business profits of a resident of one country (defined with respect to the United States as including a United States corporation) are taxable in the other country only to the extent

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1. 26 C.F.R. § 1.482 - 1(b).

2. 26 C.F.R. § 1.482 - 1(a)(c).

3. *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

4. Income Tax Treaty Between Norway and the United States, CCH Tax Treaties Service ¶¶ 6053, *et seq.*

those profits are attributable to a fixed place of business through which that resident engages in industrial or commercial activities in the other country.[5] One hundred percent of the income thus determined to be attributable to a fixed place of business in either country is subjected to taxation by that country,[6] and relief from double income taxation (as between Norwegian taxes and taxes imposed by the federal government of the United States) is afforded by the treaty, by provisions for tax credits by the U.S. to U.S. residents and tax credits and exemptions by Norway to residents of Norway.[7]

In addition, by statute, to avoid double taxation by the United States of the income of taxpayers under its jurisdictional power, the United States allows foreign tax credits or deductions to offset its inclusion of foreign source income in the U.S. base.[8] There is no comparable relief afforded by California at the state level.

The California worldwide combined method of state taxation ignores this treaty based arm's-length method of determining income, under which 100% of Phillips' income earned in Norway has been subjected to Norwegian tax, and instead requires a formulary apportionment of all worldwide income, including that allocated by treaty to Norway. The inevitable result of this inherently arbitrary requirement coupled with the dictates of the U.S./Norway tax treaty is a gross multiple taxation of foreign earned income. The California method necessarily results in arbitrarily and unreasonably attributing to California income earned and already fully subjected to tax in a foreign country like Norway.

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5. Ibid, footnote 4, ¶¶ 6056, 6057 and 6075.
6. Ibid., footnote 4, ¶ 6077.
7. Ibid., footnote 4, ¶ 6076.
8. 26 U.S.C. § 901.

To illustrate such effects, Phillips has computed the income that would be attributable to Norway using the California three-factor apportionment formula. This formulary apportionment results in attributing income, in millions of dollars, to Norway for 1979 and 1980 of $198.8 and $433.9, respectively. The taxes which were actually paid on income earned using the arm's-length method of determination were, in millions of dollars, $645.1 and $1,467.4 or 324% and 338% of the income apportionable to Norway under the California basis of formulary apportionment.

As is shown by the fact that taxes paid by Phillips to Norway on income earned there are more than triple the total amount of income that California's method of apportionment would allocate to Norway, it is obvious that Phillips' total income earned in Norway had to have actually been, and was, substantially in excess of the amount indicated by California's method of apportionment. In the case of a California taxpayer, like Phillips, which also conducts business in foreign jurisdictions, California's method of apportionment, if it is to comply with the mandates of the Due Process and Interstate and Foreign Commerce Clauses, must allocate to California only that portion of the taxpayer's worldwide income which fairly represents the taxpayer's actual income from California business. California apparently recognizes these mandates and seeks compliance with them by application to the taxpayer's total worldwide income of a fraction, in which payroll, property and sales in California constitute the numerator, and those items worldwide constitute the denominator. If this fraction is applied to total worldwide income, it indisputably attributes an unreasonably and unrealistically *low* portion of Phillips' worldwide income to Norway, as shown by the 324% and 338% of tax thereon paid to Norway. It is axiomatic that this method must necessarily attribute an unreasonably and unrealistically

high portion of the remainder of Phillips' worldwide income to California and/or other jurisdictions. This illustration shows that California's method of apportionment arbitrarily leads to grossly distorted results, and is obviously and grossly defective in general and as applied to Phillips. When such a formula leads to a grossly distorted result, the Due Process Clause of the United States Constitution is violated. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 326 (1968).

Even though a tax of over 300% of income determined under California's method of apportionment has been paid to the country in which the income was earned, California's method would subject this income to an additional duplicative tax, by including it, and income from other foreign jurisdictions, in Phillips' total income for purposes of California's formula. Under this California computation, a negative Norway income would result after Norway taxes are deducted, but no credit or deduction is allowed under California law for these foreign taxes paid. The effect therefore becomes a California tax on the taxes paid to another jurisdiction such as Norway.

Inasmuch as most countries utilize the arm's-length method of determining taxable income, California's use of the worldwide combined method of determining taxable income inevitably leads to a certain unavoidable degree of multiple taxation. Such a taxing method cannot be allowed, by this Court, to persist.

II

The Worldwide Combined Method of Apportioning Income Is Unconstitutional Under the Commerce Clause of the United States Constitution

This Court stated in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) that two additional require-

ments over and above those applicable under the Interstate Commerce Clause must be met when testing a tax on instrumentalities of foreign commerce under the Foreign Commerce Clause. "First, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'." *Japan Line*, 441 U.S. at 451. These requirements must be applied to California's worldwide combined method of apportioning income.

As demonstrated above, the worldwide combined method of apportioning income as is done by California, in conjunction with a foreign country's determination of income by the arm's-length method, inevitably results in international multiple taxation and the imposition of tax on more than "one full value".

"Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the state, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." *Japan Line*, 441 U.S. at 447-48 citing *Evco v. Jones*, 409 U.S. 91 (1972), at 94, quoting *J. D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938), at 311. That principle, announced by this Court in the course of its consideration of California's taxation of items of personal property, is equally applicable to California's taxation of a taxpayer's income. The burden on foreign commerce is not less onerous or intolerable because of the object of the tax in question here.

Norway and the United States have entered into a treaty whereby income is determined utilizing the arm's-length method.[9] Norway has the right to tax income within its jurisdiction as determined under that treaty. Norway is not required to make any correlative adjustment to accommodate the perceived taxing right of California on that income.

The second additional principle enunciated in *Japan Line* is that a tax cannot prevent the federal government from "speaking with one voice when regulating commercial relations with foreign governments."[10] Through the treaty process the U.S. Government has spoken for all the states. Norway has one tax treaty with all of the United States, not fifty individual treaties.[11] Income taxable by the United States and Norway is determined under the treaty by use of the arm's-length method. California's laws and similar laws of other states cannot be permitted to ignore the treaty process in violation of the mandates of the United States Constitution and this Court. "Where those laws conflict with a treaty, they must bow to the superior federal policy." *Zschernig v. Miller*, 389 U.S. 429, at 440 (1968).

Because the California worldwide combined method of apportioning income inherently conflicts with the arm's-length method embodied in the Income Tax Treaty between Norway and the United States results in multiple taxation, the California worldwide combined method of apportioning income violates the precepts which must be satisfied when considering foreign commerce questions, as enunciated in *Japan Line*, hence, is unconstitutional under the Commerce Clause. *Japan Line*, 441 U.S. 434, at 448.

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9. **Footnote 4.**

10. ***Japan Line*, 441 U.S. 434, at 451.**

11. **Footnote 4.**

CONCLUSION

When applied in conjunction with the arm's-length method of apportioning income, the unilateral application by a state of the worldwide combined method of apportioning income, as in the case of California, results in unconscionable multiple international taxation. There is no tribunal other than this Court that exists to safeguard U.S. taxpayers against this result. Consequently, the Court should act to prevent the duplicative tax results by invalidating the use of combined formulary apportionment, as applied by states such as California, to income that has all been taxed by a foreign sovereign.

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BRIEF AMICUS CURIAE OF SHELL PETROLEUM N.V.

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TABLE OF CONTENTS

	Page
Table of Authorities	ii
Preliminary Statement	1
Interest of Amicus Curiae	2
Summary of Argument	4
Argument	5
I. The California Franchise Tax As Applied Violates The United States Constitution	6
A. The Franchise Tax Board's Application Of The Unitary Tax Violates The Foreign Commerce Clause	6
B. The Franchise Tax Board's Application Of The California Franchise Tax Violates The Due Process Clause	11
II. The Franchise Tax Board's Actions With Respect To Foreign Source Income Contravene The Universal International Acceptance Of The Arm's-Length Method And Rejection Of Formula Apportionment	15
Conclusion	20

TABLE OF AUTHORITIES

	Page
CASES:	
ASARCO Inc. v. Idaho State Tax Comm'n, 50 U.S.L.W. 4962 (U.S. June 29, 1982)	4, 11, 12, 13, 15
Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924)	15
Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., No. 81-349 (U.S. Sup. Ct.)	6, 8, 19
Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980)	11, 12
F. W. Woolworth Co. v. Taxation and Revenue Dep't of the State of New Mexico, 50 U.S.L.W. 4957 (U.S. June 29, 1982)	11
Geofroy v. Riggs, 133 U.S. 258 (1890)	16
Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931)	13
Hauenstein v. Lynham, 100 U.S. 483 (1880)	15
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	6, 8, 9
Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980)	12, 13
Nielsen v. Johnson, 279 U.S. 47 (1929)	15
Shell Petroleum N.V. v. Mary Ann Graves, et al., No. C 81 4302 MHP (N.D. Cal. filed Nov. 4, 1981)	2, 8
United States v. Belmont, 301 U.S. 324 (1937)	15
United States v. Pink, 315 U.S. 203 (1942)	15
Wallace v. Hines, 253 U.S. 66 (1920)	11
Ware v. Hylton, 3 U.S. (3 Dall.) 199 (1796)	15
UNITED STATES CONSTITUTION:	
U.S. Const. art. I, § 8, cl. 3 (Foreign Commerce Clause)	*passim*
U.S. Const. art. II, § 2, cl. 2 (Treaty-Making Power)	*passim*
U.S. Const. art. VI, cl. 2 (Supremacy Clause)	15
U.S. Const. amend. XIV, § 1 (Due Process Clause)	*passim*

Page

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Internal Revenue Code § 482 17

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BRIEF AMICUS CURIAE OF SHELL PETROLEUM N.V.

PRELIMINARY STATEMENT

Shell Petroleum N.V. files this brief *amicus curiae* with the consent of both parties in order to put before the Court certain views as to whether the California franchise tax may be applied to the income of foreign affiliates of corporate taxpayers doing business in California through the combination of the income of that taxpayer with that of its foreign affiliates and the apportionment of that combined income to California. The constitutionality of including the income of a foreign subsidiary of a domestic corporation in the unitary formula was ruled upon by the Court of Appeal for the State of California in *Container Corp. of America v. Franchise Tax Board,* 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981).

While the *Container* case arises in the context of the Franchise Tax Board's combination and apportionment of the income of foreign subsidiaries of a domestic corporation, the Franchise Tax Board has also taken the further step of attempting to tax the income of a domestic company's foreign parent and the parent's worldwide subsidiaries and affiliates. These attempts by the Franchise Tax Board pose even more compelling constitutional arguments against the application of combination and apportionment of foreign source income than those made here by the appellant, Container Corporation of America ("Container Corporation"), and raise certain additional issues, not present here, concerning whether such attempts violate United States treaties and international conventions. Those constitutional and treaty issues have been raised in an action currently pending in the United States District Court for the Northern District of California, *Shell Petroleum N.V. v. Mary Ann Graves, et al.*, No C 81 4302 MHP (N.D. Cal. filed Nov. 4, 1981).

INTEREST OF AMICUS CURIAE

Shell Petroleum N.V. is a company of The Netherlands and is accorded special rights and protections by the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands, the United States Netherlands Double Taxation Convention of 1948, as amended, and general principles of international law. Shell Petroleum N.V. is also accorded certain rights and protections under the United States Constitution both directly and by virtue of the "national treatment" guarantees of both the Treaty of Friendship, Commerce and Navigation and the Double Taxation Convention. These rights and protections may be affected by the decision herein.

Shell Petroleum N.V. has its principal place of business at The Hague. Sixty percent of the equity shareholding in Shell Petroleum N.V. is held by the Royal Dutch Petroleum Co., a company incorporated in The Netherlands. The remaining 40

percent is held by The "Shell" Transport and Trading Company, Public Limited Company, a company incorporated in England.

Shell Petroleum N.V. and an affiliated company, The Shell Petroleum Company Limited, together hold, directly or indirectly, the investments representing interests in the over 900 other Royal Dutch/Shell companies operating in over 100 countries. Included among Shell Petroleum N.V.'s holdings are Shell Oil Company ("Shell Oil") and Scallop Nuclear Inc. ("Scallop Nuclear"). During the period 1967 through 1976 for Shell Oil and 1973 through 1976 for Scallop Nuclear, those two companies engaged in business in California and were subject to the California corporate franchise tax. For those periods of time, the Franchise Tax Board ("the FTB") has applied the franchise tax unitary formula so as effectively to tax not only the income of Shell Oil and Scallop Nuclear, but also the income of their foreign parent, Shell Petroleum N.V., and all of its subsidiaries and affiliates, which comprise the more than 900 Royal Dutch/Shell companies operating worldwide.

As a result of that conduct, Shell Petroleum N.V. has filed an action against the members of the FTB of the State of California in the U.S. District Court for the Northern District of California. (Nov. 4, 1981, No. C 81 4302 MHP). Shell Petroleum N.V. claims that the FTB's application of the corporate franchise tax to the combined and apportioned income of the parent of Shell Oil and Scallop Nuclear and the more than 900 other Royal Dutch/Shell companies violates certain provisions of the two treaties between the United States and The Netherlands, the U.S. Constitution, and general principles of international law. Shell Petroleum N.V. has moved for summary judgment and the FTB has moved to dismiss. The District Court heard oral argument on both motions on June 1, 1982, and they are presently sub judice.

As a foreign parent company whose income, together with that of its affiliates and subsidiaries, has been combined, apportioned and then taxed by the FTB through California's practices of worldwide combination and apportionment, Shell Petroleum N.V. has a special interest in the issues presented by

Container Corporation's appeal to this Court. Because it is a foreign parent company, and because it is entitled to rights and protections under U.S.-Netherlands treaties and international law, as well as the Constitution, Shell Petroleum N.V. believes that it can present views not heretofore expressed which may be of use to the Court in resolving the issues presented.

Shell Petroleum N.V. submits this brief *amicus curiae* for the primary purpose of placing before the Court the distinctive considerations applicable to a foreign parent company protected by the principles of strict territoriality of taxation embodied in various bilateral treaties, multinational conventions and international law which are relevant to the Court's disposition of this case. Shell Petroleum N.V. also supports the position taken in this appeal by Container Corporation.

SUMMARY OF ARGUMENT

The FTB's application of the unitary tax to the income of foreign affiliates of domestic corporations doing business in California violates the Foreign Commerce and Treaty-Making Powers Clauses of the U.S. Constitution, because such a method of taxation threatens Federal uniformity in the conduct of foreign relations and creates an impermissible risk of multiple taxation. The policies underlying the Foreign Commerce Clause are particularly important when the income sought to be taxed by a unitary apportionment formula is that of a foreign parent company and its primarily foreign subsidiaries because the perceived mistreatment of enterprises owned by foreign nationals or companies is most likely to result in adverse impacts on the United States' foreign relations.

Furthermore, the FTB violates the Due Process Clause of the United States Constitution by using a unitary tax to combine and apportion income when (i) there is no nexus between the taxing state and the interstate or foreign activities from which the income is derived and (ii) there is no rational relationship between the income attributed to the taxing state and the intrastate values of the enterprise. Under this Court's recent decision in *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. 4962 (U.S. June 29, 1982), the State of

California may not reach out to tax unrelated income earned elsewhere under the guise of "apportioning" such income to California where the result of its "apportionment" is to impose California taxes on the income earned abroad through the conduct of separate businesses by the foreign affiliates of a domestic corporation.

In addition, specific provisions of United States treaties with foreign countries and general principles of international law protect foreign companies affiliated with a domestic taxpayer from the practices of combination and apportionment pursued by the FTB in California. Foreign parent companies such as Shell Petroleum N.V. are entitled to the rights granted by such modern Friendship, Commerce and Navigation Treaties as the Treaty of 1956 between the United States and The Netherlands. That Treaty contains provisions incorporating the internationally accepted principle of strict territorial limitation on taxation. Those provisions, as well as certain additional protections and rights in that Treaty and others, have been violated by the FTB's application of California's unitary tax to the income of Shell Petroleum N.V. and its foreign affiliates.

ARGUMENT

The United States Constitution limits state taxation of the income of companies engaged in interstate and foreign commerce. In particular, the Foreign Commerce Clause, U.S. Const. art. I, § 8, cl. 3, the Treaty-Making Power, U.S. Const. art. II, § 2, cl. 2, and the Due Process Clause of the Fourteenth Amendment, U.S. Const. amend. XIV, § 1, require a state to limit its taxation to income related to the business activities conducted by the taxpayer within the state. Furthermore, international treaties establishing standards governing the taxation of foreign companies and their property, enterprises and interests, limit the taxing power of the FTB, since it has long been established that any state law inconsistent with a Federal treaty is preempted.

I. THE CALIFORNIA FRANCHISE TAX AS APPLIED VIOLATES THE UNITED STATES CONSTITUTION.

A. The Franchise Tax Board's Application Of The Unitary Tax Violates The Foreign Commerce Clause.

The FTB's application of the unitary tax formula to the income of foreign affiliates of domestic corporations doing business in California violates the Foreign Commerce Clause, U.S. Const. art. I, § 8, cl. 3, and the Treaty-Making Power, U.S. Const. art. II, § 2, cl. 2 of the United States Constitution under this Court's precedents, notably *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). This conclusion was endorsed by the United States Government, speaking through the Solicitor General, as *amicus curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (U.S. Sup. Ct.)[1] The United States Government further took the position that the policies underlying the Commerce Clause apply with even greater force in those situations in which the income sought to be apportioned and taxed by a state is that of a foreign parent company. *Id.* at 18-19.

The United States Constitution vests in the Federal Government the power to regulate foreign commerce and to make treaties. Crucial to the conduct of foreign affairs is federal uniformity—the ability of the government to speak with one voice. The United States and every other significant trading nation in the world taxes foreign corporations doing business within their territorial jurisdictions through a local subsidiary by treating the local subsidiary as an independent entity, determining the subsidiary's income on the basis of its separate accounts and looking to the foreign parent's accounts only when necessary to adjust transactions between parent and subsidiary to arm's-length values. This approach, commonly referred to as the arm's-length method, has not only been universally followed, but has also been adopted in numerous bilateral and

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[1] The Solicitor General and the Department of Justice filed an *amicus* brief in that case on behalf of the United States Government. Brief *amicus curiae* of the United States Government, *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349 (U.S., filed January 14, 1982) (hereinafter "U.S. Brief Amicus").

multilateral treaties, including the Modern Bilateral Convention for the Prevention of the Double Taxation of Income and Property (Mexico Draft 1943; London Draft 1946), the Model Double Taxation Convention on Income and on Capital, Organization for Economic Cooperation and Development (1977); the Model Double Taxation Convention Between Developed and Developing Countries, United Nations (1980); the Double Taxation Convention of 1948 between the United States of America and the Kingdom of The Netherlands, as amended; the Convention of Establishment of 1959 between the United States of America and France; the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands; and the Treaty of Friendship, Commerce and Navigation of 1946 between the United States of America and the Republic of China.

Application of a state formula-apportioned income tax to the income of foreign affiliates, conflicts sharply with the policies embodied in those treaties and more generally impairs the unity of policy necessary for the proper conduct of foreign affairs. The Solicitor General illustrates this conflict by means of a hypothetical example, in which a domestic corporation operating at a loss, and having no federal taxable income under the arm's-length method, falls subject to state taxation on foreign source income earned by foreign affiliates. *See* U.S. Brief Amicus, *supra,* at 2. This hypothetical situation has become a reality as a result of the FTB's actions. Through the application of the state franchise tax law, the FTB has determined that Scallop Nuclear earned some $46,000,000 in California income during the period 1973 through 1976, despite the fact that Scallop Nuclear actually lost some $390,000,000 during this period. With respect to Shell Oil, the FTB has apportioned to the State of California an amount equal to *92.6%* of Shell Oil's *total* income despite the fact that Shell Oil operated throughout the United States and in several foreign countries and had less than 20% of its sales, property and payroll (those being the relevant California apportionment factors) located in California.

The need for federal uniformity in conducting foreign affairs is particularly apparent when differing state and federal policies toward foreign countries prompt international protest, creating the potential for retaliation against the nation as a whole, not just against the state posing the conflict. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 450. Such a threat of retaliation is particularly pronounced where state officials are acting against a foreign parent company, because the interest of a foreign government in protecting the legitimate rights of its nationals is strongest in such a case.

During the past two years, the FTB's actions have stirred increasing complaints from the international community. On March 19, 1980, the Italian Government, acting on behalf of the European Economic Community ("EEC"), protested the FTB's actions to the United States Government. *See* Brief *amicus curiae* of the Kingdom of The Netherlands, *Shell Petroleum N.V. v. Graves, supra,* app. (N.D. Cal. filed March 22, 1982). On October 30, 1981, that protest was renewed by the United Kingdom on behalf of the EEC. On December 17, 1981, the Chancellor of the Exchequer of the United Kingdom protested to the Secretary of the Treasury and specifically asked that the United States Government address the issue in *Chicago Bridge*. *See* U.S. Brief Amicus, *supra,* app. The Governments of The Netherlands and Japan have voiced their opposition to the FTB's actions through their briefs amicus in *Shell Petroleum N.V. v. Graves, supra.* Brief *amicus curiae* of the Government of the Kingdom of The Netherlands, *supra;* Brief *amicus curiae* of the Government of Japan (N.D. Cal. filed May 17, 1982). Most recently, on June 29, 1982, the Government of Belgium, acting on behalf of the EEC, reiterated to the State Department the Community's opposition to the FTB's practice of combination and apportionment in the international sphere, terming it "entirely unsatisfactory".

In response to the request of the United Kingdom and after consultation with the Departments of State, Treasury and Commerce and the U.S. Trade Representative, the Solicitor General, speaking on behalf of the United States Government, has officially taken the position that application of a formula-apportioned state income tax to the worldwide income of a

multinational group of companies is constitutionally barred because it interferes with the Federal Government's need to speak with one voice in addressing this sensitive issue. In light of the growing concerns expressed by various foreign governments concerning the extraterritorial assertions of state tax power that conflict with federal policy, the Federal Government's expression of a need for uniformity in this area should be accepted by this Court as a sufficient basis, under *Japan Line,* to preclude the imposition of a formula-apportioned state income tax on the income of foreign affiliates as violative of the Foreign Commerce Clause.

A state tax is also unconstitutional under the Foreign Commerce Clause if it creates a substantial risk of multiple taxation in international commerce. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 446. Multiple taxation will necessarily occur when the income of foreign companies is generally taxed by the internationally accepted arm's-length method and the State of California applies formula apportionment to foreign source income. Appellant Container Corporation has demonstrated that the profitability of business operations outside the United States is normally greater. Consequently, the FTB's application of its three-factor apportionment formula to foreign source income will generally serve to import into California income already taxed abroad and thus result in multiple taxation, as it unquestionably has in the cases of Container Corporation and Shell Petroleum N.V. While the apportionment of income earned within the United States, under the supervision of this Court, can be monitored to avoid multiple taxation, quite the opposite results when foreign income is apportioned. The peculiar dangers posed by formula-apportioned taxes in matters of foreign commerce result from this Court's inability to ensure full and fair apportionment when one of the taxing entities involved is foreign. *Id.* at 447.

The burdens of multiple taxation can arise where the foreign company is a subsidiary, as in the case of Container Corporation. However, where the foreign company is the parent and its domestic subsidiary is relatively small compared to the overseas operations of the foreign parent and its foreign subsidiaries, the FTB's use of formula apportionment can have

particularly spectacular distorting effects because of the disproportionate profitability of foreign operations. Such is the case when the FTB seeks to apply the unitary apportionment formula to the income of a foreign parent, Shell Petroleum N.V., and its over 900 subsidiaries and affiliates operating worldwide. The FTB seeks to tax Scallop Nuclear on $46,000,000 of "apportioned" income when Scallop Nuclear in fact lost over $390,000,000. The FTB also seeks to impose its taxes on an amount equal to virtually all of Shell Oil's income (92.6%) during the period in question. Such gross distortion necessarily results in substantial multiple taxation, because the income of the foreign companies being combined, apportioned and then taxed has already been subject to and in fact taxed in the relevant foreign countries.

Furthermore, as the Solicitor General has noted, other burdens are placed exclusively on foreign commerce, in violation of the Foreign Commerce Clause, when a state seeks to consolidate the income of foreign affiliates with a domestic company, particularly when the foreign affiliate is the parent company. Requiring a foreign parent and its foreign affiliates to conform to U.S. accounting principles and California accounting rules and to convert all entries to U.S. dollars will be extremely burdensome to foreign commerce. U.S. Brief Amicus, *supra,* at 19. In addition, international commerce will be severely disadvantaged if massive reporting requirements are imposed on foreign companies. In its current proceedings against Shell Petroleum N.V.'s income, for example, the FTB has demanded the disclosure by Shell Petroleum N.V. and its over 900 worldwide subsidiaries and affiliates of their complete corporate histories and details of their individual businesses, such as the names of principal customers, revenues, profits and losses, and internal management structure. Those requirements pose severe and costly administrative burdens on foreign commerce. Those burdens are further enhanced where the foreign subsidiary of a foreign parent is engaged in business in a country sensitive to the release of such information, for in such a case the government involved may be particularly angered by intrusive informational demands of a subnational unit of a country in which neither the foreign subsidiary nor its parent has any permanent establishment or is engaged in

business. The imposition of these burdens, which are more pronounced in the case of a foreign parent company, constitutes a plain violation of the Foreign Commerce Clause of the U.S. Constitution.

B. The Franchise Tax Board's Application of the California Franchise Tax Violates the Due Process Clause.

The basic requirements of the Due Process Clause for state taxation of the income of a business operating in interstate or foreign commerce are now well established. This Court recently reiterated the "general principle [that] a State may not tax value earned outside its borders". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

In applying a unitary apportionment formula to income from without the state, a state is bound by two requirements of the Due Process Clause. First, there must be a "nexus" or "connection" between the interstate or foreign activities of the taxpayer and the taxing state. Second, there must be a "rational relationship between the income attributed to the State and the intrastate values of the enterprise". *See ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4964; *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. 207, 219-220 (1980); *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 436-37 (1980). The requirements of the Due Process Clause are *not* satisfied by a formula which combines and apportions all income that in some manner benefits or " 'adds to the riches of the corporation' ". *F. W. Woolworth Co. v. Taxation and Revenue Dep't of the State of New Mexico,* 50 U.S.L.W. 4957, 4959 (U.S. June 29, 1982), quoting *Wallace v. Hines,* 253 U.S. 66, 70 (1920).

The "nexus" required by the Due Process Clause for permissible state taxation of a business operating in interstate and foreign commerce is normally established if the corporation whose income is being taxed "avails itself of the 'substantial privileges of carrying on business' within the State". *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 200, quoting

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. at 435, 444-45. That nexus is clearly lacking when the FTB apportions the worldwide income of a foreign parent and its foreign subsidiaries, which did not themselves engage in business activities in the state during the taxing period. Where there are no such business activities within the state, the nexus requirement is satisfied only if "intrastate and extrastate activities [subject to formula apportionment] formed part of a *single unitary business". ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4964-65, quoting *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 438.

The essence of the unitary business principle, as this Court has defined the term, is the coordination and integration of various elements of the taxpayer's business in order to produce a stream of income for the taxpayer. *See, e.g., Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 223-26. Even if a taxpayer's intrastate and interstate or international activities are determined to constitute a "unitary business" generating a "unitary stream of income", *id.,* at 226, not all of the taxpayer's income is necessarily subject to apportionment. A state must exclude from the application of the unitary apportionment formula all income "derive[d] for 'unrelated business activity' which constitutes a 'discrete business enterprise' ". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4965, quoting *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 224, and *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 442, 439.

The FTB's actions with respect to Shell Petroleum N.V. cast additional light on the manner in which the FTB is disregarding both elements of the due process standard in pursuing foreign source income. The FTB has insisted on treating Shell Oil and Scallop Nuclear as unitary with Shell Petroleum N.V. despite its knowledge of the uncontroverted facts that Shell Oil and Scallop Nuclear operate businesses completely separate and independent from the businesses operated by other Royal Dutch/Shell companies abroad. Shell Oil is a major public company which operates under the direction

of its officers, none of whom are employees of Shell Petroleum N.V., and its Board of Directors, a majority of whom have during all relevant periods not been officers or directors of Shell Petroleum N.V. or any of its other affiliates.

The FTB's grounds for deeming Scallop Nuclear a part of a single unitary business comprising all of the businesses of all the 900 Royal Dutch/Shell companies are equally flimsy. For purposes of Scallop Nuclear, the FTB appears to rely on the simple fact of investment and ownership of stock in Scallop Nuclear. Scallop Nuclear's only business is that of General Atomic Company, a partnership in which Gulf Oil Corporation and Scallop Nuclear are equal 50% partners. The business of General Atomic is managed by its partnership committee in which Gulf Oil Corporation and Scallop Nuclear hold equal numbers of seats. Scallop Nuclear is not even engaged in the same type of business as any other Royal Dutch/Shell company, it being engaged in research activities directed toward the development of nuclear reactors.

The second requirement of the Due Process Clause is that there be a "rational relationship" between the income that is sought to be attributed to a state through the use of an apportionment formula and the "intrastate values of the enterprise" being taxed. A rational relationship is absent when the income apportioned and taxed is derived from discrete business enterprises that "have 'nothing to do with the activities' " of the company in the state, in " 'any business or economic sense' ". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4968, quoting *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 439-42. Furthermore, a state's apportionment formula may not attribute to the state "income out of all appropriate proportion to the business transacted by the [taxpayer] in that State", *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 135 (1931).

The Franchise Tax Board, by misapplying the "unitary business" method of taxation to a misdefined notion of a "unitary business", has vastly overstated the alleged California income of companies doing business in California. For example, for the six-year period of 1967 through 1972, the FTB

claims as California's share approximately *92.6%* of the *total* income of Shell Oil from all sources. This figure bears no rational relationship to the California activities of Shell Oil, a company headquartered in Texas, doing business throughout the United States and in several foreign countries and having less than 20% of its property, sales and payroll located in California.

The FTB's claimed "portion" of Scallop Nuclear's income is even more irrational. During the years 1973-1976, the General Atomic partnership incurred aggregate losses of $780,218,000, of which Scallop Nuclear's share was one half, or $390,109,000.[2] Since Scallop Nuclear had no other business activities, those losses constituted its only "income" in California or elsewhere. The FTB, however, asserts that Scallop Nuclear earned approximately $46,000,000 in income in California for that four-year period, thereby fabricating approximately $436,000,000 of additional income. That California income figure bears no rational relationship to the business activities of Scallop Nuclear in California or indeed anywhere else.

The incredible distortions which thus arise from the FTB's application of its three-factor apportionment formula are the inevitable result of applying its apportionment formula to foreign source income. The essentially common economic conditions which may make formula apportionment an acceptable approach for purposes of allocating income derived from a unitary business operating in the United States do not apply to income produced by worldwide businesses. Vastly varying economic conditions render wholly unreasonable the assumption that like amounts of property, payroll and sales will generate like amounts of income. The application of the FTB's three-factor apportionment formula to foreign source income will therefore generally allocate to California income which bears no reasonable relation to the intrastate values involved. The FTB's attempts to reach this foreign income, like the efforts of the State Tax Commission of Idaho, are properly "viewed as

[2] For United States income tax purposes for those years Scallop Nuclear reported an aggregate loss of $273,268,967.

'a mere effort to reach profits earned elsewhere under the guise of legitimate taxation' ", *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4968, quoting *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271, 283 (1924), and therefore are clearly violative of the Due Process Clause of the U.S. Constitution.

II. THE FRANCHISE TAX BOARD'S ACTIONS WITH RESPECT TO FOREIGN SOURCE INCOME CONTRAVENE THE UNIVERSAL INTERNATIONAL ACCEPTANCE OF THE ARM'S-LENGTH METHOD AND REJECTION OF FORMULA APPORTIONMENT.

In addition to violating the Foreign Commerce and Due Process Clauses, the FTB's application of the unitary tax to the income of foreign companies violates numerous treaties between the United States and foreign countries and international conventions. Shell Petroleum N.V. is a company incorporated in The Netherlands and, therefore, is entitled to the protections of the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands. That treaty is one of a series of such treaties entered into by the United States after World War II, generally referred to as the modern Friendship, Commerce and Navigation treaties.

As a matter of Federal constitutional law, U.S. Const. art. VI, cl. 2, the standards set out in those treaties are "the supreme law of the land". The treaties therefore limit the taxing power of the FTB, since it has long been established that any state law inconsistent with a Federal treaty is to that extent preempted. *See, e.g., Ware v. Hylton,* 3 U.S. (3 Dall.) 199 (1796); *Hauenstein v. Lynham,* 100 U.S. 483, 488-89 (1880); *Nielsen v. Johnson,* 279 U.S. 47 (1929); *United States v. Belmont,* 301 U.S. 324, 327, 331 (1937); *United States v. Pink,* 315 U.S. 203, 230 (1942).

The Treaty of Friendship, Commerce and Navigation between the U.S. and The Netherlands contains several provisions that proscribe the manner in which the FTB is applying its unitary tax formula. Article XI of the treaty specifically deals

with the taxation in one country of the companies of the other country. That article, *inter alia,* prohibits American governmental authorities from imposing any tax upon income "in excess of that *reasonably allocable or apportionable to* [*the*] *territories* [of the taxing authority]" (emphasis supplied).

Courts have long recognized that international treaties are based upon and informed by prevailing principles of international law. *See Geofroy v. Riggs,* 133 U.S. 258, 271 (1890). Accordingly, interpretation of modern Friendship, Commerce and Navigation treaties must be made in the context of the established international law and practice on which they are based.

The development of modern principles of international law applicable to assertions of national taxing powers derives from the work of the League of Nations. The position of the League, as set forth in early draft conventions, was that foreign companies doing business in the taxing country through a "permanent establishment" could be taxed only on the income "produced in" or "derive[d]" in the territories of the taxing state. *See* Modern Bilateral Convention for the Prevention of the Double Taxation of Income and Property, art. IV, para. 3; Protocol, art. VI, para. 1(A), (Mexico Draft 1943; London Draft 1946).[3] The income to be taxed "cannot exceed the earnings that are the direct result of the activities of the establishment concerned", *see* Commentary to Mexico and London Drafts at 17-18.

In order to determine what income was "derived" or "produced" within the taxing country, the League proposed reliance on the separate accounts of the permanent establishment, treating each permanent establishment as an independent enterprise. Income from transactions between the related enterprises was to be valued as if the transactions were between "independent persons dealing at arm's length", and the separate accounts of the permanent establishment could be

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[3] League of Nations Doc. C.88.M.88.1946.IIA: Fiscal Committee—London and Mexico Model Tax Conventions, Commentary and Text.

"rectif[ied]" "when necessary". Protocol, art. VI, para. 1(B)(Mexico Draft; London Draft).[4] *See also* Protocol, art. VII (Mexico Draft; London Draft).

The primary reason for the League's use of separate accounting as the "fundamental procedure for the determination of the profits attributable to each country in which an enterprise has an establishment" was that "it gives the taxation of branch establishments a strictly territorial scope not extending beyond the boundaries of the countries concerned". Commentary to Mexico and London Drafts at 18.

In addition to choosing separate accounting as the appropriate method for determining income derived within the taxing territory, the League's draft conventions forebade the consolidation or combination of the foreign parent company with its domestic subsidiary for tax purposes. Subsidiaries were not "permanent establishments" of the parent company for purposes of the draft conventions. Protocol, art. V, para. 8 (Mexico Draft; London Draft). Instead, subsidiaries were to be treated as independent enterprises. Accordingly, only the domestic subsidiary, not the foreign parent, could be taxed by virtue of the fact that such a subsidiary operated within the taxing jurisdiction. *See* Commentary to Mexico and London Drafts at 17.

The League's position with respect to international limitations on state taxation powers was adopted and continued by a number of international organizations in the postwar period, including those of which the United States is a member. Most notably, the Organization for European Economic Cooperation ("OEEC"), which subsequently became the Organization for Economic Cooperation and Development ("OECD"), has prepared draft conventions continuing the recognition of the international practice that only income derived by a permanent establishment within the taxing jurisdiction, as measured by the use of the arm's-length method and separate accounting, can be taxed.

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[4] This is the same legal standard employed by the United States, as reflected in § 482 of the Internal Revenue Code and accompanying Regulations.

In 1977, the Committee on Fiscal Affairs of the OECD issued its Model Double Taxation Convention on Income and on Capital ("1977 OECD Model Convention"). Under that Model Convention, as with other international model conventions, income of a parent corporation cannot be taxed in another country solely because a subsidiary is located in that other country. "The profits of an enterprise of a Contracting State shall be taxable only in that State *unless* the enterprise carries on business in the other Contracting State through a permanent establishment situated therein", art. 7, para. 1 (emphasis supplied), and a subsidiary does not constitute such a permanent establishment of the parent, art. 5, para. 7.

If such a permanent establishment exists, the taxing jurisdiction may tax only the profits "attributable" to that permanent establishment, art. 7, para. 1. If transactions between related companies have not been at arm's-length, as would have been the case had the companies been unrelated, the taxing jurisdiction may adjust the profits of the establishment to the arm's-length figure, art. 7, para. 2. However, such adjustments must always start with the "real facts" as they "appear from the business records of the permanent establishment", and be based on figures available in the open market. Commentary to art. 7.

The United Nations has adopted the same view of the accepted international law standards on taxation. *See, e.g.*, United Nations, *Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries* (7th Report, 1978). The United Nations' Group of Experts has specifically based its work on the efforts of the OECD, *id.* at 2, and has "unanimously recognized the validity of the arm's-length principle" in determining the profits of a permanent establishment for purposes of taxation of a multinational business. *Id.* at 62. *See generally* United Nations, *Model Double Taxation Convention Between Developed and Developing Countries* (1980).

The same principles have been adopted by the United States in its tax treaties with other nations, in recognition of the established international norm. The U.S.—Netherlands Double Taxation Convention of 1948, as amended, for example, specifically outlines the international approach of permanent establishments, separate accounting and arm's-length transactions in Article III, paragraphs 1 and 2.

The principles of strict territoriality of taxation, adopted by the numerous treaties and international conventions described above and constituting an integral part of international law, unquestionably prohibit the FTB's application of its practices of combination and apportionment to the income of Shell Petroleum N.V. and its foreign affiliates. Appellant Container Corporation, as a U.S. national, is of course not in a position to assert the rights vested in foreign nationals by these various treaties. However, Shell Petroleum N.V. submits that the pattern of these treaties and conventions is nonetheless relevant to the analysis of the constitutional issues raised by Container Corporation. Those treaties and conventions reflect universal acceptance of the arm's-length method of international taxation. The actions of the FTB in combining the income of Container Corporation with that of its foreign subsidiaries and apportioning the total income to California by application of its three-factor apportionment formula is plainly and unquestionably inconsistent with that universal practice. The universality of acceptance of the arm's-length method by the community of nations and its repeated reaffirmation by the United States lends strong support to the view, expressed by the Solicitor General in *Chicago Bridge*, that the need to speak with a single voice in matters of foreign commerce requires the prohibition under the Foreign Commerce and Treaty-Making Powers Clauses of the FTB's application of its principles of combination and formula apportionment where foreign source income is involved.

CONCLUSION

The FTB's application of the California unitary tax to the income of foreign affiliates of companies doing business in California violates the Foreign Commerce, Treaty-Making Powers and Due Process Clauses of the U.S. Constitution.

In any event, because of the special policy considerations applicable to the taxation of foreign companies under the U.S. Constitution, and the rights and protections accorded foreign companies by U.S. treaties and international conventions, this Court should not decide the case before it on grounds that would foreclose a foreign parent company from raising claims that the application of a unitary tax to foreign income violates the U.S. Constitution, U.S. treaties, and general principles of international law.

Respectfully submitted,

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CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal From the Court of Appeal
of the State of California
for the First Appellate District

BRIEF FOR

SONY CORPORATION
KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS)
KANKEIREN (KANSAI ECONOMIC FEDERATION)
ELECTRONIC INDUSTRIES ASSOCIATION OF JAPAN
HORIBA INTERNATIONAL CORPORATION
KYOTO CERAMIC CO., LTD.
MATSUSHITA ELECTRIC INDUSTRIAL CO., LTD.
NIPPON ELECTRIC CO., LTD.

AS AMICI CURIAE IN SUPPORT OF APPELLANT

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TABLE OF CONTENTS

PAGE

Statement of Interest 1

Summary of Argument 5

Argument:

I. The Rationale of *Japan Line, Ltd.* Precludes the Imposition of the Combined Report/Formula Apportionment Method on Foreign Income of Foreign Multinational Enterprises 8

II. Taxation of Foreign Commerce is Governed by an International Network of Treaties Which Speak With "One Voice" in Favor of the Arm's Length Method 10

III. This Nation Must Speak With "One Voice" In Taxing Foreign Multinational Enterprises To Avoid Straining Foreign Relations And Hampering Foreign Investment, And To Avoid Any Potential Risk Of Retaliatory Taxation 14

IV. The Combined Report/Formula Apportionment Method Applied to Foreign Income Results in Actual Double Taxation of Foreign Multinational Enterprises and Thus is Constitutionally Prohibited 16

V. The Combined Report and Formula Apportionment Methods Were Peculiarly Developed For Purposes Of State Taxation Of United States Operations, And Cannot Equitably Or Constitutionally Be Extended Abroad 18

Conclusion 22

Appendix

TABLE OF AUTHORITIES

CASES — PAGE

Adams Exp. Co. v. Ohio State Auditor, 166 U.S. 185 (1897) 19

Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938) 9

Bass, Ratcliff & Gretton v. State Tax Commission, 226 U.S. 271 (1924) 10

Board of Trustees v. United States, 289 U.S. 48 (1933) 9

Butler Bros. v. McColgan, 315 U.S. 501 (1941) 19

Complete Auto Transit v. Brady, 430 U.S. 274 (1977) 9

Evco v. Jones, 409 U.S. 91 (1972) 9

Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931) 17

J. D. Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938) .. 9

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) ..... *passim*

Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980) 10

Norfolk & Western R. Co. v. State Tax Commn., 390 U.S. 317 (1968) 17

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920). 19

Washington Revenue Department v. Stevedoring Association, 435 U.S. 734 (1978) 9

UNITED STATES CONSTITUTION

Foreign Commerce Clause

Article I, Section 8, Clause 3 ..... *passim*

STATUTE

Internal Revenue Code § 891, and testimony of John S. Nolan before the Senate Finance Committee, *Hearings on State Taxation of Interstate Commerce and Worldwide Corporate Income*, June 24, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 21 16

TREATIES — PAGE

Organization of Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977), Articles 7 and 9 ..... 11, 12

United States Treasury Department's Model Income Tax Treaty of May 17, 1977 ..... 11, 12

1 CCH Tax Treaties, pp. 17-19 11

1 CCH Tax Treaties, §§ 151, 153 12

HISTORICAL AUTHORITIES

McGraw-Hill, *Business Week*, 11/2/81 at pp. 131-132, and p. 156 14

1917 Nat. Tax Ass'n. Proceedings 185, at 194 20

OECD, Report of the OECD Committee on Fiscal Affairs "Model Double Taxation, Convention on Income and Capital" (1977), published as a separate publication by the OECD 12

Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979) 12

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Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report 12

Staff Policy Report of the Advisory Commission on Intergovernmental Relations, *"State Taxation of Multinational and Multistate Corporations"* (9/4/81) 11

HISTORICAL AUTHORITIES — PAGE

Statement of Assistant Secretary of Treasury, Lawrence N. Woodworth, before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines,* July 19 and 20, 1977, 95th Congress, First Session, Washington, D.C., U.S. Government Printing Office, 1977, p. 28 11

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Surrey, *"Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions,"* 10 Law and Policy in International Business, 409, 410 (1978) (The International Journal of Georgetown University Law Center) 11

No. 81-523

In The

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,
vs.
FRANCHISE TAX BOARD,
Appellee.

On Appeal From the Court of Appeal of the State of California for the First Appellate District

BRIEF FOR

SONY CORPORATION
KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS)
KANKEIREN (KANSAI ECONOMIC FEDERATION)
ELECTRONIC INDUSTRIES ASSOCIATION OF JAPAN
HORIBA INTERNATIONAL CORPORATION
KYOTO CERAMIC CO., LTD.
MATSUSHITA ELECTRIC INDUSTRIAL CO., LTD.
NIPPON ELECTRIC CO., LTD.

AS AMICI CURIAE IN SUPPORT OF APPELLANT

STATEMENT OF INTEREST

This Brief is submitted with the written consent of the parties on file with the Clerk of this Court.

The *amici* constitute various Japanese parent corporations which have United States subsidiaries operating in the United States, as well as three Japanese trade associations, Keidanren

(Japan Federation of Economic Organizations)[1], Kankeiren (Kansai Economic Federation)[2], and Electronic Industries Association of Japan.[3]

The interest of the trade associations in this proceeding stems from the fact that some of the members thereof constitute foreign parent corporations with United States subsidiaries operating in the United States. Similarly, the interest of each of the *amici* companies stems from the fact that each of them is a foreign parent corporation with a United States subsidiary operating within the United States.

Some of the *amici* are currently challenging the propriety of the combined report/formula apportionment method, applied on a worldwide basis, at the administrative level in one or more states, and the others expect to challenge the method in due course.

Under the combined report/formula apportionment method (simplistically referred to by some commentators as the "unitary approach," "unitary apportionment approach," or by similar terms), foreign parent corporations are being forced by

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[1] Keidanren (Japan Federation of Economic Organizations) is a private, non-profit organization representing all branches of economic activities in Japan. As of December 1981, the organization consists of 916 members, of which 110 are associations, such as trade associations and regional economic organizations, and the balance are leading Japanese enterprises and foreign companies operating in Japan. The purpose of Keidanren is to maintain close contact with various economic sectors in Japan and abroad in an effort not only to find practical solutions to economic problems but also to contribute toward the sound development of the economies of Japan and the world.

[2] Kankeiren (Kansai Economic Federation), established on October 1, 1948, has a membership of over 500 corporations, over 100 organizations, as well as a number of individuals of the Kansai area. Its objective is to contribute to the sound development of the Japanese economy by submitting the opinions and recommendations of the Kansai business community to the relevant authorities.

[3] Electronic Industries Association of Japan is a trade association with approximately 600 members, of which approximately 70 constitute foreign parent corporations with United States subsidiaries operating in the United States.

various states to, in effect, file a consolidated return with all of their worldwide subsidiaries (euphemistically called a "combined report" of a unitary group). The total worldwide income of the consolidated group is then allocated to a specific state under the so-called "three-factor formula" apportionment method, i.e., on the basis of the relative amounts of their property, payroll, and sales in the taxing state, as compared to the total worldwide property, payroll, and sales of the consolidated group.

The *amici* are entirely different from Appellant in that they are foreign corporations, whereas the Appellant is a United States parent corporation.

The problem of imposing the combined report/formula apportionment method is entirely different when a foreign parent corporation is involved than it is when a United States parent corporation is involved. Foreign nations are not concerned with whether the United States imposes the combined report/formula apportionment method upon an affiliated group with a United States parent corporation. However, foreign nations are intensely concerned when a state imposes the combined report/formula apportionment method upon an affiliated group with a *foreign parent* corporation.

The combined report/formula apportionment method does not conform to international principles of taxation, and, indeed, such method is completely antithetical to international principles of taxation. Under the tenets laid down by this Court in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), any method of taxation affecting foreign commerce which does not conform to international principles of taxation violates the Foreign Commerce Clause because this Nation must speak with "one voice," in matters of "foreign intercourse and trade," and this Nation, as well as many other nations of the world, has adopted the arm's length method [i.e., measuring income as if all relationships were between independent parties] as the bedrock of international tax relationships.

The *amici*, as foreign parent corporations, do not presume herein to advise this Court as to the proper method of taxing income earned within the United States. They are only concerned that the measurement of that income earned within the United States be determined under the internationally accepted arm's length method. Once the United States income is so determined, the taxation of that income becomes a matter of internal concern within the United States. This concept of limiting the application of formula apportionment to the territorial boundaries of the United States (*i.e.*, the "water's edge"), and using the arm's length method to separate foreign income from United States income, is commonly referred to as the "water's edge" rule.

The concern of the *amici* is to alert this Court to the fact that the principles which this Court may enunciate in this case with respect to United States parent corporations, by reason of the sovereign right of the United States to tax its own corporate citizens, have entirely different Constitutional implications under the Foreign Commerce Clause if such principles are extended to affiliated groups owned by foreign parent corporations (*i.e.*, " foreign multinational enterprises"). It is imperative, in the case of foreign multinational enterprises, that this Nation speak with "one voice," and that this Court make it clear that the combined report/formula apportionment method cannot be imposed upon foreign income of such foreign multinational enterprises.

SUMMARY OF ARGUMENT

This Court, in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), laid down two principles, over and above those applicable to interstate commerce questions, against which state taxes must be tested under the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3). One is that the tax cannot prevent the Federal government from "speaking with one voice" with respect to international relations. The second is that the tax, "notwithstanding apportionment," must not create a substantial risk of multiple taxation.

Combined reporting/formula apportionment, when applied to foreign income of a foreign multinational enterprise, violates both these principles. Tax harmonization is of paramount importance in international commercial relations. Thus, it is of paramount importance that the Federal government speak with "one voice" in this area, and it has so spoken. Indeed, most of the non-communist major nations in the world have also so spoken, as have various world organizations. Every nation has emphatically endorsed the arm's length method rather than formula apportionment as the touchstone of international tax harmonization.

If this Court were to embrace the combined report/formula apportionment method as applicable to foreign income of foreign multinational enterprises, the Constitutional requirement that the Federal government speak with "one voice" would be emasculated.

The parties in the instant case will no doubt extensively debate whether arm's length or combined report/formula apportionment method more accurately measures worldwide income, and we, too, will touch upon that question herein. In the case of the foreign income of a foreign multinational enterprise, however, that question need never be reached. In

that arena, both Constitutionally (under the Foreign Commerce Clause) and pragmatically, the threshold critical inquiry is to determine if there is some common touchstone of taxation which has been agreed upon by the competing nations.

Within the United States, the formula apportionment method makes sense on the theory that, among other things, there is comity and uniformity as between the states, and the United States courts are in a position to remedy any injustice. At the international level, however, this is not true. The nations of the world have agreed upon an entirely different touchstone of taxation; namely, the arm's length method. Therefore, the arm's length method must, both equitably and under the Foreign Commerce Clause, be the method endorsed by this Court as to foreign income of foreign multinational enterprises.

Formula apportionment has been rejected by the Federal government, and (so far as is known) by all nations of the world which impose an income tax. Formula apportionment (and certainly combined reporting) is aberrational, asymmetrical, and repugnant to every country, including, at the Federal level of taxation, the United States.

The combined report/formula apportionment method prevents the Federal government from speaking with "one voice" and this, alone, renders the method invalid as applied to foreign income of foreign multinational enterprises. However, in addition, the combined report/formula apportionment method violates the second principle set forth in *Japan Line, Ltd.* with respect to foreign commerce in that it creates the risk of multiple taxation, and even more than that, multiple taxation in fact.

The combined report/formula apportionment method originated as a judicially created concept which was borrowed from property tax cases as an expedient, albeit rough, method of dividing profits within the various states of the United States. It has been developed and nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns

are reasonably comparable and where the currency is the same. Fundamental to the rationale of the method is the assumption that all states within the United States are homogeneous in terms of economic and taxing conditions. This basic assumption is not applicable on a worldwide basis and the method becomes inequitable and distortive when extended to the nonhomogeneous world.

The inequity of extending combined report/formula apportionment abroad is exacerbated by the fact that this method results in a heavier tax burden on affiliates of foreign corporations operating within the United States than on affiliates of United States corporations operating solely in the United States. Within the United States, when one state utilizes formula apportionment, correlative adjustments should be made by other states, and, if not made, the courts can relieve any inequity. In the international arena, no such correlative adjustment occurs since all foreign nations utilize the arm's length method.

Because combined reporting/formula apportionment violates internationally agreed principles of taxation, and because it is asymmetrical and distortive, the attempted imposition of combined report/formula apportionment by states such as California has engendered a number of formal protests by foreign countries, and this raises the concern, expressed by this Court in *Japan Line, Ltd.*, that an asymmetrical state tax may lead to potential retaliation by disadvantaged foreign nations.

ARGUMENT

I.

THE RATIONALE OF *JAPAN LINE, LTD.* PRECLUDES THE IMPOSITION OF THE COMBINED REPORT/FORMULA APPORTIONMENT METHOD ON FOREIGN INCOME OF FOREIGN MULTINATIONAL ENTERPRISES

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) this Court determined that when a state seeks to tax instrumentalities of foreign commerce, two additional requirements, beyond those applicable to interstate commerce, must be met under the Foreign Commerce Clause of the Federal Constitution. First, the state tax must not "impair federal uniformity in an area where federal uniformity is essential" and, in that regard, "[f]oreign commerce is preeminently a matter of national concern."[4] In short, the Federal government must speak " 'with one voice when regulating commercial relations with foreign governments.' "[5]

Among the reasons why this Court indicated that the Federal government must speak with one voice is that even "[i]f the State imposes an apportioned tax, international disputes over reconciling apportionment formula may arise."[6] If a state tax creates an "asymmetry in the international tax structure" then foreign nations "may retaliate."[7]

Second, the state tax must not create "a substantial risk of international multiple taxation."[8]

As stated by this Court, if the state tax "contravenes either of these precepts it is unconstitutional under the Commerce Clause."[9]

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[4] 441 U.S. 434, at p. 448.
[5] *Ibid.*, at p. 451.
[6] *Ibid.*, at p. 450.
[7] *Ibid.*, at p. 450.
[8] *Ibid.*, at p. 451.
[9] *Ibid.*, at p. 451.

Both of the prescribed requirements would be violated if this Court were to embrace the combined report/formula apportionment method with respect to non-United States operations of foreign multinational enterprises. " 'In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power,' "[10] and this Court has stressed "the need for uniformity in treating with other nations."[11]

Japan Line, Ltd. involved a property tax, rather than an income tax, but the constitutional limitations which apply to state taxing powers do not differentiate among different kinds of taxes, and it is obvious from the *Japan Line, Ltd.* opinion that this Court did not intend to confine that decision to property taxes. This Court's discussion of the governing principles did not distinguish between various kinds of taxes.

In *Japan Line, Ltd.*, this Court distinguished *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), and *Washington Revenue Department v. Stevedoring Association*, 435 U.S. 734 (1978), as involving interstate commerce rather than foreign commerce.[12] *Complete Auto Transit* involved a privilege tax measured by gross sales or gross income, and *Washington Revenue Department* involved an occupation privilege tax measured by gross income. This Court also cited *Evco v. Jones*, 409 U.S. 91 (1972), involving a gross receipts tax, and *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938), involving a state gross income tax,[13] and quoted from *Board of Trustees v. United States*, 289 U.S. 48 (1933), which was an import duty case.[14]

It is clear that this Court in *Japan Line, Ltd.* meant to enunciate principles applicable to all types of taxes. The gravamen of an invalid tax is its burden on commerce and not

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[10] 441 U.S. 434, at p. 448.
[11] *Ibid.*, at p. 448.
[12] *Ibid.*, at p. 445.
[13] *Ibid.*, at p. 446.
[14] *Ibid.*, at p. 448.

what it is called. Taxes which result in multiple burdens on interstate or foreign commerce are invalid regardless of the kind of tax involved.[15] Most importantly, however, the nature of the tax is obviously irrelevant to the necessity that the Federal government speak with "one voice."

II.

TAXATION OF FOREIGN COMMERCE IS GOVERNED BY AN INTERNATIONAL NETWORK OF TREATIES WHICH SPEAK WITH "ONE VOICE" IN FAVOR OF THE ARM'S LENGTH METHOD

Multinational trade must be governed by international rules of taxation, not peculiar taxing concepts of nations, and certainly not of political subdivisions of nations. It is imperative that the United States, as well as the other nations, speak with "one voice" in agreeing upon such international rules. Most of the non-communist major countries of the world, including, of course, the United States, have entered into an extensive network of treaties covering the avoidance of double taxation of income. The United States has entered into income tax conventions with twenty-nine countries, and treaties with some

[15] Although this Court declined to apply the *Japan Line* rationale in *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), which involved an income tax, the *Mobil* situation was correctly analyzed by this Court as involving only issues of interstate commerce, not foreign commerce, since *Mobil* conceded that the dividend income in question could be taxed by the State of New York. Moreover, *Mobil* involved only the issue of multiple taxation, and not the issue that the Nation must speak with "one voice."

Similarly, this Court's decision in *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924), which upheld apportionment (not combined reporting) as to a foreign parent corporation operating directly within the United States, involved, insofar as the Foreign Commerce Clause was involved, only the limited issue of whether the tax constituted a direct tax on foreign commerce, and not the issue that the Nation must speak with "one voice." Moreover, international economic, trade, and tax relationships today can hardly be compared to those which existed in 1918 (the fiscal year in issue), over 60 years ago.

twelve additional countries have been signed but are not yet in effect.[16] The touchstone of taxation under all of these treaties is the arm's length method, *viz.*, the "water's edge" rule.[17]

The proper allocation of income is a major matter in the negotiation and implementation of treaties between nations. International conformity on this issue is critical "if there is to be order and rationality in the tax relationships among nations."[18] "[T]he rules of national tax systems and their interaction with the systems of other countries," are "[a]mong the major impediments to freer capital and technology flows."[19]

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[16] 1 CCH Tax Treaties, pp. 17-19.

[17] Staff Policy Report of The Advisory Commission on Intergovernmental Relations, published as a separate report entitled "State Taxation of Multinational and Multistate Corporations" (9/4/81). For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, pp. 14-17.

The Advisory Commission on Intergovernmental Relations is the permanent commission established by Congress in 1959 to monitor intergovernmental relations and to make recommendations for change. Members include federal, state and local elected and appointed officials and private citizens.

See also Articles 7 and 9 of both the Organization of Economic Cooperation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977) and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977. See, fns. 22, 23.

[18] Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 Law and Policy in International Business, 409, at p. 409 (1978) (The International Journal of Georgetown University Law Center). Professor Surrey is a learned tax expert, a Professor of Law, Harvard Law School, former Assistant of Tax Policy, U.S. Treasury Department (1961-69), and Special Advisor to the Rapporteur, United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries.

[19] Statement of Assistant Secretary of Treasury, Lawrence N. Woodworth, before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines*, July 19 and 20, 1977, 95th Congress, First Session, Washington, D.C., U.S. Government Printing Office, 1977, p. 28.

"Tax treaties" embodying the arm's length method "represent a highly developed area of international cooperation," and "[f]ew fields come to mind in which international groups have worked so consistently for so long."[20] The stakes in tax harmonization involve more than a mere "desire for orderliness in international tax matters." Unless there is such harmonization, "double taxation of income . . . [will result] in a loss of international investment and income flows."[21]

Various world organizations have repudiated formula apportionment for international use. The arm's length method, *viz.*, the "water's edge" rule, is embodied in both The Organization for Economic Co-operation and Development ("OECD") Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977)[22] and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977.[23] The United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries repudiated formula apportionment as recently as 1978,[24] as did The Organization for Economic Co-operation and Development ("OECD") in 1979.[25]

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[20] Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury, before the Subcommittee on Oversight, House Committee on Ways and Means, *Hearings on Income Tax Treaties*, April 29, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 61.

[21] *Ibid.*, fn. 17, at p. 6.

[22] OECD, Report of the OECD Committee on Fiscal Affairs "Model Double Taxation, Convention on Income and Capital" (1977), published as a separate publication by the OECD. Reprinted at 1 CCH Tax Treaties, § 151.

[23] 1 CCH Tax Treaties, § 153.

[24] Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report. For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, p. 21.

[25] Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979). The Organization for Economic Co-operation and

(Footnotes continued on following page)

In September, 1981, the Staff of the Advisory Commission of Intergovernmental Relations ("ACIR") recommended in a special report that Federal legislation be enacted which would embody the "water's edge" rule as to foreign parent corporations and formula apportionment as to United States parent corporations.[26] This recommendation of the "water's edge" rule by the ACIR Staff as to a foreign parent is the rule that the *amici* herein contend is required by the Foreign Commerce Clause of the United States Constitution.

The conflict between a state's use of combined reporting/formula apportionment and the arm's length, "water's edge" rule utilized by the Federal government and all other nations has been recognized as being of serious proportions in that "the application of a state's unitary system to foreign operations disrupts implementation of the nation's policy of harmonizing, through our network of bilateral tax treaties, our country's tax system with the tax systems of our treaty partners . . . [and is] a substantial irritant in international tax and trade policy."[27]

It is obvious, therefore, that the combined report/formula apportionment method, if imposed on foreign commerce of foreign multinational enterprises, impairs Federal uniformity where "[f]ederal uniformity is essential,"[28] and, accordingly, violates the tenet requiring that the Federal government speak with "one voice" in such matters.

(Footnotes continued from previous page)

Development (OECD) was set up under a convention signed in Paris on December 14, 1960, which provides that the OECD shall promote policies designed to, *inter alia*, contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with the international obligations. The members of the OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, pp. 18-20.

[26] *Ibid*, fn. 17.

[27] *Ibid.*, fn. 17, at p. 11.

[28] 441 U.S. 434, at p. 448.

III.

THIS NATION MUST SPEAK WITH "ONE VOICE" IN TAXING FOREIGN MULTINATIONAL ENTERPRISES TO AVOID STRAINING FOREIGN RELATIONS AND HAMPERING FOREIGN INVESTMENT, AND TO AVOID ANY POTENTIAL RISK OF RETALIATORY TAXATION

The reaction of foreign nations to any proposed imposition of combined report/formula apportionment with respect to foreign operations of foreign parent corporations has been vehemently adverse. Formal letters of protest have been lodged with the United States government by Belgium, Canada, France, Italy, and the United Kingdom, and the nine governments of the European Economic Community, the Japanese government has included the issue in its agenda of grievances in recent trade talks between Japan and the United States, and resolutions condemning such method have been recently adopted by several foreign trade associations.[29]

There also is little doubt but that the attempted imposition of combined reporting/formula apportionment has hampered and increasingly will hamper foreign investments in those states which are attempting to impose the method, and potentially within the entire United States. Reports indicate that investments in California by foreign multinationals have been postponed or abandoned, or have been made in states which do not attempt to impose such a method.[30] The attempted imposition of such a method has also been properly criticized as "unfair," and as a "quick-fix search for new revenues today" which will have to be paid for "in lost growth tomorrow."[31]

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[29] *Ibid.*, fn. 17, at pp. 11-12. Copies of the letters of protest filed by the governments of Canada, France, and the United Kingdom, and by the European Economic Community, and a recent resolution by the Council on Unitary Taxation Issues of Kansai Area, Japan, a Japanese trade association, are included in the Appendix hereto, pp. 1-13, 24-27.

[30] McGraw-Hill, Business Week, 11/2/81, at pp. 131-132. For the convenience of this Court, selected extracts from that publication which contain more extensive discussions of the material referred to in this Brief are included in the Appendix hereto, pp. 22-23.

[31] *Ibid.*, at p. 156.

This Court can imagine the outrage which those in the United States would feel if local jurisdictions of a foreign country, such as provinces, cantons, cities, or the like, were to impose income taxes on subsidiaries of United States corporations doing business in that country on the combined report/formula apportionment basis. The parent United States corporation would rightfully be incensed at demands by local jurisdictions that the entire affiliated group throughout the world file a combined report in that locality and provide records and information about the entire world affairs of the affiliated group, and translate the income and expense of the entire worldwide group into some form acceptable to the locality.

Is it surprising, therefore, that foreign parent corporations are incensed at the actions of those states within the United States which attempt to impose such burdens upon the foreign parent corporation and other corporations within their worldwide affiliated group which have no contact with, nor income from, either that locality or the United States as a whole?

The fact that combined reporting/formula apportionment is so fundamentally violative of international principles of taxation, and is so asymmetrical and distortive in nature, highlights the concern expressed by this Court in *Japan Line, Ltd.*, that such attacks can cause "foreign nations disadvantaged by the levy . . . [to] retaliate against American-owned instrumentalities present in their jurisdictions."[32] In that event, "the nation as a whole would suffer."[33]

A number of foreign countries are so incensed at the inequity and inappropriateness of combined reporting/formula apportionment as applied to foreign multinational enterprises that "[t]hese countries could, therefore, conclude that some appropriate response is required to demonstrate their concern,"[34] which could be "some form of retaliation."[35]

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[32] *Ibid.*, fn. 4, at p. 450.

[33] *Ibid.*

[34] *Ibid.*, fn. 17, at p. 16.

[35] *Ibid.*

Ironically, the United States in 1934 established a precedent for retaliatory taxation when France subjected United States corporations to what was deemed by the United States to be inequitable taxation, and although the dispute with France was ultimately settled by treaty, the retaliatory provision enacted by the United States remains a part of the Internal Revenue Code.[36]

Thus, it is patently apparent that the Federal government must speak with "one voice" in taxing foreign income of foreign multinational enterprises, and individual states cannot be permitted to interfere in this area which has been Constitutionally mandated under the Foreign Commerce Clause as within the exclusive province of the Federal government.[37]

IV.

THE COMBINED REPORT/FORMULA APPORTIONMENT METHOD APPLIED TO FOREIGN INCOME RESULTS IN ACTUAL DOUBLE TAXATION OF FOREIGN MULTINATIONAL ENTERPRISES AND THUS IS CONSTITUTIONALLY PROHIBITED

The combined report/formula apportionment method creates more than the risk of multiple taxation on multinational enterprises; it produces multiple taxation in fact. Thus, the method cannot withstand the constitutional scrutiny required by *Japan Line, Ltd.* Foreign parent companies, and each of their subsidiaries which operate in a foreign country, are taxed by the foreign country or countries in which the particular corporation

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[36] *Ibid.*, at p. 17. See IRC § 891, and testimony of John S. Nolan before the Senate Finance Committee, *Hearings on State Taxation of Interstate Commerce and Worldwide Corporate Income*, June 24, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 21.

[37] It is, of course, well settled that the Foreign Commerce Clause, even though "Congress has not pre-empted the field by affirmative regulation," affords "protection from state legislation inimical to the national commerce." 441 U.S. 434, at p. 454.

operates on the uniform, internationally accepted, arm's length principle. The income being earned by each of these corporations in each of the countries in which it operates is taxed in full and without any apportionment. To the extent that any state within the United States applies the combined report/formula apportionment method on a worldwide basis, it attributes to that state a certain portion, as determined by the formula, of income which already has been taxed 100% by a foreign country (and at the foreign local level in countries such as Japan, Germany, Switzerland and Canada, which impose taxes at both the national and local level).[38] Since a foreign country has already taxed 100% of that income, the imposition by a state of a tax on a portion of that same income subjects that income to double taxation.

The problem of multiple taxation is exacerbated by the fact that foreign parent corporations with affiliates operating within the United States are required, under the combined report/formula apportionment method, to endure a heavier tax burden on their affiliates' operations within the United States than are affiliates of United States parent corporations operating solely within the United States, since, within the United States, there is some uniformity in the allocation of income as between the states, but this would not be true as to income earned in foreign jurisdictions.

To the extent that affiliates of United States parent corporations operate solely within the United States and one state utilizes the formula apportionment method, correlative adjustments should be made by other states in the allocation of income to those other states under the formula apportionment method. To the extent the states are not uniform in applying the formula method, the United States courts have the power to relieve any inequity.[39]

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[38] In some instances, however, as is true with respect to Appellee, Caterpillar Tractor Co., the formula can attribute less income to a state than the arm's length method.

[39] See, *e.g.*, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), *Norfolk & Western R. Co. v. State Tax Comm.*, 390 U.S. 317 (1968).

On the other hand, to the extent that income of a foreign parent corporation and/or its foreign affiliates is, through the combined report/formula apportionment method, deemed to have been earned in a state, no correlative adjustment in the allocation of income is possible in the foreign country, since all foreign countries utilize international arm's length principles. Further, no power exists in the United States courts to remedy this obvious injustice.[40]

V.

THE COMBINED REPORT AND FORMULA APPORTIONMENT METHODS WERE PECULIARLY DEVELOPED FOR PURPOSES OF STATE TAXATION OF UNITED STATES OPERATIONS, AND CANNOT EQUITABLY OR CONSTITUTIONALLY BE EXTENDED ABROAD.

Since combined reporting/formula apportionment, when applied to foreign income of foreign multinational enterprises, demonstratively interferes with the Federal government's need to speak with "one voice," this Court does not need to reach the question of whether combined reporting/formula apportionment is, on the merits, appropriate in such circumstances.[41] However, even on the merits, combined report/formula apportionment comes up wanting.

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[40] In *Japan Line, Ltd.*, this Court observed that under these circumstances "multiple taxation inevitably results." 441 U.S. 434, at p. 447. Methods under foreign law for according double tax relief are geared to the arm's length method and thus normally can be expected to accord either no relief, or only limited relief, from double taxation resulting from formula apportionment.

[41] In any event, the formula apportionment method, "when applied to an enterprise touching two or more countries requires some international authority or arrangement to be operable, and hence at least on a short-range horizon does not seem feasible." Surrey, *op. cit.*, fn. 18, at p. 416.

The combined report/formula apportionment method involves two separate concepts of state taxation which are peculiar to state taxation within the United States. The requirement of a combined report, i.e., the required filing of a combined return by a related group of corporations, is required by only a few states, such as California (and, now, Illinois). Formula apportionment, on the other hand, is used in one form or another with respect to United States operations by virtually all states imposing an income tax, although there are great variations in the manner in which the method is actually applied.

The formula apportionment method originated as a judicially created concept which was borrowed from the property tax cases as an expedient, albeit rough, method of dividing the total profits of an enterprise among the various states in which the enterprise operates.[42] It was developed and has been nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably homogeneous, and where the currency is the same. Theoretically, if all states were to apply the concept uniformly (which they do not) and if the tax rates of all states were approximately equal (which they are not), there would be complete and simple harmonization under the formula apportionment method (and even under the combined report method) in that a taxpayer operating solely within the United States would be taxed only once on its income at the state level (and only once at the Federal level). A taxpayer would then be content, since it would be immaterial to the taxpayer how the respective states in which it operated divided up one single state tax burden. Accordingly, the crucial impetus in the development of the

[42] See, *e.g.*, *Adams Exp. Co. v. Ohio State Auditor*, 166 U.S. 185 (1897), *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Butler Bros. v. McColgan*, 315 U.S. 501 (1941).

formula apportionment method within the United States has been the quest for uniformity and comity among the states, rather than mathematical precision.[43]

Formula apportionment purports to accurately measure income, but, in fact, it mechanically divides overall profits of an enterprise on the basis of deemed economic activity in a taxing jurisdiction without regard to the realities of the marketplace. The arm's length method, on the other hand, attempts to track the actualities of the marketplace, where profits (or losses) do not conform to this simplistic formula apportionment method.[44] Formula apportionment conclusively presumes that profits (or losses) flow uniformly from property, payroll, and sales. Although taxpayers have the right to demonstrate that the results of the formula method are inequitable, the burdens imposed upon a taxpayer attempting to demonstrate the arbitrariness of the formula method are almost insurmountable. In truth, however, the formula method is every bit as imperfect as (and sometimes more imperfect than) the arm's length method. The primary virtue of the formula method is its perceived simplicity of administration rather than the commonly expressed rationalization that it more precisely measures income than the arm's length method.

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[43] This was early recognized by Professor T. S. Adams of Yale, one of the early pioneers on the subject, who declared in 1917 to the National Tax Association:

> "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdications."

1917 Nat. Tax Ass'n. Proceedings 185, at 194. A Committee of the National Tax Association, echoing Dr. Adams' views, put the matter thus in 1922:

> "All methods of apportionment of trading profits are arbitrary . . . [T]here is no one right rule of apportionment, . . . [T]he only right rule . . . is a rule on which the several states can and will get together as a matter of comity."

"Report of Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business," 1922 Nat. Tax Ass'n. Proceedings 198, at 201-02.

[44] Surrey, *op. cit.*, fn. 18, at p. 415.

Fundamental to the rationale of the formula apportionment method is the assumption that all of the states have at least roughly comparable economic and taxing conditions. On a worldwide basis, however, this rationale becomes inapplicable.

There are wide ranges in wage rates and productivity of labor in different areas of the world; substantial differences exist in costs and productivity of plant, equipment, and other property; risk factors and rates of return are different, currencies are different, and conversion rates fluctuate. Moreover, substantial practical administrative difficulties exist in trying to accommodate books and records and different accounting practices in foreign countries to American standards, and taxing patterns differ in other countries, with the result, since many states give neither a credit nor a deduction for foreign income taxes, that the income base against which the formula method is applied is not comparable, and the product of the formula method is accordingly greatly distorted.

Thus, the formula apportionment method, which was developed for application to activities within the reasonably homogeneous United States, becomes inequitable and distortive when applied to the nonhomogeneous world. World conditions are simply far more diverse than conditions as between the states of the United States, and, accordingly, combined report/formula apportionment method is inappropriate for worldwide application.

CONCLUSION

Whatever decision this Court may make with respect to the Appellant herein, it is respectfully submitted that this Court should make it clear that the arm's length method is the internationally accepted rule of law with respect to the *foreign income* of *foreign multinational enterprises;* that this Nation must speak with "one voice" in international commercial relations; and that any attempt by a state to impose the combined report/formula apportionment method on such *foreign income* is therefore in clear violation of the Foreign Commerce Clause of the United States Constitution.

Respectfully submitted,

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Dated: July 30, 1982

APPENDIX

TABLE OF CONTENTS

	PAGE
Canada Letter of Protest	1
France Letter of Protest	4
United Kingdom Letter of Protest	7
European Economic Community Letter of Protest	11
Extracts from Staff Report of Advisory Commission on Intergovernmental Relations dated 9/4/81	14
Extracts from Report of OECD Committee on Fiscal Affairs, "Transfer Pricing in Multinational Enterprises" (1979)	18
Extracts from Seventh Report, Report of the Group of Experts on Tax Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978)	21
Extracts from "Business Week" dated 11/2/81	22
Resolution of the Council on Unitary Taxation Issues of Kansai Area, Japan	24

Canada

September 26, 1980

The Honorable
Allan J. MacEachen,
Deputy Prime Minister and
Minister of Finance of Canada,

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting States to establish its status as a religious, scientific, literary, educational or charitable organization entitled to exemption under paragraph 1 of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's-length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters.

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of America and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

France

His Excellency
Francois de Laboulaye
Ambassador of France

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The Frence Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this

Convention only $12,000 is taxable by France, the French tax will be 60 percent ($^{12,000}/_{20,000}$) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

United Kingdom

British Embassy
Washington, D.C. June 23, 1980

Hon. Harry F. Byrd, Jr.
Russell Senate Office Building
U.S. Senate, Washington, D.C.

My Dear Senator Byrd: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. Anson, Minister, Economics

(Press release issued by the British Embassy
Information Department)

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on

26 August 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9 (4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States.(*sic*) It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although (*sic*) the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

11

European Economic Community

Ambasciata D'Italia,
Washington, D.C., March 19, 1980

To the Department of State, Washington, D.C.:

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine ECC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

[SEAL]

Paola Pansa Cedronio,
Ambassador of Italy

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the groups as

a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries."

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9(4) of the Treaty, which if supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress, S 983, S 1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Extracts from Staff Report of Advisory Commission on Intergovernmental Relations Dated 9/4/81.

[Footnotes Omitted]

Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments. [p. 5.]

Tax treaties represent a highly developed area of international cooperation. Few fields come to mind in which international groups have worked so consistently for so long. [p. 6.]

The stakes in tax harmonization, or coordination of the tax systems of various countries, involve more than a desire for orderliness in international tax matters. Without such harmonization, double taxation of income could easily occur, resulting in a loss of international investment and income flows. [p. 6.]

Specifically, tax harmonization cannot occur without an *internationally accepted set of standards* which serve as the foundation for all tax treaty negotiations. [Emphasis in original.]

Two important sets of rules for this purpose are: (1) those defining a *permanent establishment* in the host country, since the host country can only tax business profits attributable to such a permanent establishment, and (2) those specifying procedures for accounting for transactions between related parties in measuring the income of the permanent establishment. Under these latter rules, the permanent establishment, such as a branch or subsidiary corporation, is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis;* that is, as if the related parties were dealing with each other as independent enterprises at arm's length. [Emphasis in original.]

These standards have evolved from about 50 years of effort on the part of both technical experts and negotiators of tax treaties. In 1932, the first tax convention to which the U.S. was a party, that is a tax convention with France, adopted the arm's length concept. In 1934, through work supported by the League of Nations, the first model tax treaty was developed incorporating the arm's length standard. The model income tax treaty of the Organization for Economic Cooperation and Development (OECD) most recently revised in 1977, similarly embraces this arm's length concept as does the United States' model tax treaty also most recently issued by the Treasury Department in 1977.

Thus, the standard reflected in both OECD and United States model income tax treaties is a "water's edge" rule. Permanent establishments in foreign countries are considered separate entities. Even if transactions occur between related foreign and domestic corporations, the income attributable to the foreign entity is calculated by reference to transactions between independent parties.

These water's edge rules are in sharp contrast to the procedures used by some states in this country, especially California, in applying a unitary apportionment approach to worldwide combinations of affiliated firms. [pp. 8, 9, 10.]

The conflict between state use of worldwide combination and apportionment and the water's edge rules used by the federal government and in international practice can have serious implications. First, it can interfere with national objectives in tax harmonization. Charles M. Walker, former Assistant Secretary of the Treasury for Tax Policy under the Ford Administration, clearly articulated this point in testimony before the Senate Foreign Relations Committee on the then pending U.K. Treaty.

> "The important point to grasp is that the national interest is definitely harmed by the application of a state's unitary system to foreign operations. This is because that system

disrupts implementation of the nation's policy of harmonizing, through our network of bilateral tax treaties, our country's tax system with the tax systems of our treaty partners."

Second, this conflict between federal and state rules can represent a substantial irritant in international tax and trade policy. A number of foreign governments have transmitted to the United States their formal objections to use by the states of worldwide combination in the case of corporations owned by citizens in their countries. Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of the European Economic Community (EEC), among others, have voiced such objections. Examples of their statements are reproduced in Appendix A [and in the Appendix of this Brief]. [pp. 10, 11, 12.]

One possible response by foreign governments on behalf of their taxpayers who find themselves in such circumstances could be some form of retaliation against the United States. . . . [S]everal countries consider the unitary approach as applied to worldwide combinations to result in the imposition of inequitable tax burdens by states on foreign-owned corporations and could involve state taxation of out-of-state, or extraterritorial, values. These countries could, therefore, conclude that some appropriate response is required to demonstrate their concern. U.S. corporations with subsidiaries located abroad would be the most likely targets.

Any U.S. owned firm could be the object of retaliation but particularly vulnerable to the use of worldwide combination by other countries would be firms incurring losses from foreign operations and those involved in selling abroad products manufactured in this country. In the end, of course, all countries would lose from the use of retaliation rather than negotiation as a means of settling international tax disagreements.

Ironically, the United States has already established a precedent here. In 1934, in response to extraterritorial taxation by France of U.S. corporations, the Congress enacted a provision of tax law that permitted the President of the United States, upon a finding that a foreign country has subjected U.S. citizens or corporations to discriminatory or extra-territorial taxes, to levy taxes on the citizens or corporations of that country at twice the normal rate. While the dispute with France was settled by treaty, the provision has remained part of current tax law (Section 891). [pp. 16, 17.]

Extracts from Report of OECD Committee on Fiscal Affairs, "Transfer Pricing in Multinational Enterprises" (1979)

[Footnotes Omitted]

It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with associated enterprises outside the jurisdiction of the relevant taxing authority, the profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices. This is the underlying assumption in Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital (1977) on transactions between associated enterprises. In this context, it may be noted that the arm's length approach, which underlies this report, has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries, and that there is a broad consensus among governments of developed and developing countries and MNEs [multinational enterprises] that arm's length pricing is the appropriate approach to adopt in arriving at profits for tax purposes. Modern bilateral double taxation conventions between OECD Member States and between OECD members and other States have accordingly adopted this principle. [pp. 8, 9]

Proposals for radical reformulations of the approach to intragroup transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound

relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost plus method to arrive at an arm's length price. Nor does it follow that labour costs are the same for the same labour in different countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole MNE [multinational enterprise]. While the widest range of such information may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double

taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. [pp. 14, 15.]

Extracts from Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978)

[Footnotes Omitted]

The Group of Experts was reminded that the 1974 Group of Eminent Persons Appointed to Study the Impact of Multinational Corporations on Development and on International Relations had in its May 1974 report to the Secretary-General expressed the following views:

> "We note with satisfaction that transfer pricing has been engaging the attention of the United Nations Group of Experts on Tax Treaties, the International Fiscal Association, the Organisation [sic] for Economic Co-operation and Development and the Commission of the European Communities. We trust that, as a result of their efforts, it will be possible for the international community to agree upon a code which home and host countries alike will find practicable and advantageous to enforce. . . . The general principle is to refer to 'arm's length' prices, that is, prices as they are or would be charged by an independent seller to an independent buyer.

The view was expressed that it should be stressed that the Group of Experts had unanimously recognized the validity of the arm's length principle and that Governments should apply arm's length pricing wherever appropriate. [p. 62.]

Extracts from "Business Week" dated 11/2/81.

Recent Japanese reaction to California's tax policy has been outspoken. For example, Yoshihiro Inayama, President of Japan's Federation of Economic Organizations, has written to Treasury Secretary Donald T. Regan warning that the unitary tax is holding up investments in California. And in San Francisco, Shinji Mizuchi, Senior Vice-President of Japanese-owned California First Bank, notes that Nippon Electric Corp. (NEC) recently bought land for a plant outside Sacramento, but postponed building it because of the state unitary tax. "Companies like Sony would have expanded more in California [if not for the tax]," Mizuchi adds.

In a typical reaction in Britain, Don Haywood, head of taxation for BAT Industries Ltd., whose U.S. subsidiary, Batus Inc., showed a 1980 profit of nearly $200 million, complains that his firm had "never accepted" that California had the right to tax on the unitary plan. "We have warehouses there, but I don't think we would dream of putting manufacturing facilities there," he says. Haywood notes that Batus, which owns Gimbel Bros. Inc. and Saks Fifth Avenue department stores in the U.S., recently built a papermaking plant outside of California, partly to avoid that state's taxation.

A German protest. Similar complaints come from Germany. "It would be disastrous if it [California's taxing formula] were applied in other countries," says Hans Flick, finance and tax chief of the German Chamber of Commerce & Industry. He is particularly concerned about the implications for German companies doing business in Third World nations, where the companies often endure years of losses to gain a position in the market. Such companies would "be in a permanent fight" with those countries if they followed California's example and taxed on the basis of worldwide results, Flick adds. [p. 132.]

A self-defeating tax

With money-hungry states looking for any and all ways to dredge up new revenues, it is not surprising that California and several other states are trying to slap taxes on the worldwide profits of foreign multinationals that do business within their jurisdictions [page 131]. California is being challenged in court, but whatever the final decision, trying to impose state taxes on global operations is a bad idea. If the courts do not act to squelch it, Congress should.

Last year the Supreme Court ruled that if states used a reasonable formula they could tax the global earnings of U.S. multinational corporations. Now California is leading the way in trying to give the same treatment to foreign multinationals doing business within the state.

This effort is misguided on several counts. First, it is unfair to broad-based companies that may earn very little, or may even be losing money, in a given state. More important, it sets an unwelcome precedent for other states and, even worse, for foreign countries, all of which might start trying to cut themselves in on a slice of the worldwide earnings of whatever companies happened to be operating within their borders. In Third World countries particularly, corporations typically sustain years of losses on their investments before showing any earnings. This leads to another objection: Many corporations would curtail or severely limit their investments in states and countries that tried to use them for a free ride. This is already happening in California. The lesson for it and other states is that a quick-fix search for new revenues today may have to be paid for in lost growth tomorrow. [p. 156.]

RESOLUTION
OF THE COUNCIL ON UNITARY TAXATION

We, the members of the Council on Unitary Taxation Issues[1] of Kansai Area, Japan, have met on this 10th day of December, 1981, and agreed that:

BACKGROUND OF THE UNITARY TAX PROBLEM

The so-called "Unitary Tax" (i.e., combined reporting with formula apportionment) levied on worldwide income by State Authorities of the United States, including the State of California, disregards existing national boundaries and different economic conditions and practices between Japan and the United States. Furthermore, such a method of taxation presumes unrealistically that a Japanese parent company and its subsidiary in the U.S. and other countries operate on the same profit level, in spite of different nationalities and business

[1] The Council on Unitary Taxation Issues of Kansai Area, Japan is comprised of 49 companies, all located in the Kansai area of Japan, who have formed an organization to consider and react to the imposition of California's Unitary Tax to their affiliated companies. The members of the Council are: Dainippon Screen Mfg. Co., Ltd.; The Daiwa Bank Ltd.; Daiwa House Industry Co., Ltd.; Electronic Industries Association of Japan; Hanwa Co., Ltd.; The Green Cross Corporation; Horiba, Ltd.; Iwatani Co., Ltd.; Kawasaki Heavy Industries, Ltd.; Kubota, Ltd.; Kyoto Ceramic Co., Ltd.; Kyoto Chamber of Commerce and Industry; Matsushita Electric Industrial Co., Ltd.; Minolta Camera Co., Ltd.; Murata Manufacturing Company, Ltd.; Nippon Life Insurance Company; Nippon Sheet Glass Co., Ltd.; Nissin Electric Co., Ltd.; Nissin Food Products Co., Ltd.; Omron Tateishi Electronics Company; Rohm Co., Ltd.; Santory; Sanwa Bank, Ltd.; Sanyo Electric Co., Ltd.; Sharp Corporation; Shimazu Corporation; Shimpo Industrial Co., Ltd.; The Sumitomo Bank Ltd.; Sumitomo Metal Industries, Ltd.; Taiyo Co., Ltd.; Takashimaya Company, Ltd.; Takeda Chemical Industries, Ltd.; Takenaka Komuten Co., Ltd.; Tanabe Seiyaku Co., Ltd.; The Tokai Bank Ltd.; Yanmar Diesel Engine Co., Ltd.; Wacoal Corp.

practices. Application of the Unitary Tax to Japanese parent companies is creating substantial distortion problems, unreasonable administrative burdens and significant misallocation of income.

SPECIFIC PROBLEMS WITH THE WORLDWIDE APPLICATION OF THE UNITARY TAX

We have discussed and identified the following problems resulting from application of Unitary Tax on a worldwide basis:

1. By expanding its tax jurisdiction beyond state boundaries to Japan and other foreign countries, some States, including the State of California, which employ the Unitary Taxation method on a worldwide basis cause double taxation of income earned by Japanese parent corporations.

2. Without any reasonable grounds, States, including the State of California, which employ the Unitary Taxation method on a worldwide basis levy irrational taxes on income significantly different from that which Japanese subsidiaries in the States actually earned.

3. Japanese companies which have made direct and substantial investments in the U.S. to establish subsidiaries are burdened unnecessarily and excessively, in comparison with U.S. domestic companies, by the state imposed requirement of gathering, maintaining and supplying additional accounting data.

4. Application of the Unitary Tax on a worldwide basis poses a serious impediment to further Japanese investment in the United States, despite the fact that the United States is making a serious effort to promote such Japanese investment in the U.S.

RESOLUTION AND CONCERNS

Based on the problems listed above, we have agreed to oppose, in the most decisive manner, application of the Unitary Tax on a worldwide basis.

In addition, we are deeply concerned with the recent trend in the United States of additional states in the U.S. taking steps to apply the Unitary Taxation method on a worldwide basis to foreign companies.

Furthermore, we are concerned that nations of the developing countries may also begin to apply the Unitary Tax to foreign parent corporations. If the Unitary Taxation method prevails to such an extent, internationally accepted taxation principles will be disordered and, as a result, international trade and investment would be damaged.

RECOMMENDATIONS TO THE GOVERNMENTS OF JAPAN AND THE U.S.

With this resolution, we strongly urge the governments of Japan and the United States to take the following action:

1. Both governments should exert strong initiatives to lead all the states of the United States to adopt the so-called arm's-length principle for apportioning the taxable income of Japanese parent corporations and their U.S. subsidiaries. We believe that, as the U.S.-Japan tax treaty and the U.S. Federal tax law provide, the arm's-length standard is a fair and reasonable taxation method with respect to business transactions between Japan and the United States.

2. Both governments should take notice of the substantial impact which the Unitary Tax is having on bilateral trade and investment activities. The Japanese government should explicitly notify the U.S. government that, unless the unfairness imposed by the Unitary Tax is resolved, the Japanese government shall be concerned with a critical disruption of the bilateral investment relationship.

3. In close co-operation with Western European countries, which also object to the unfairness of the Unitary Tax (applied on a worldwide basis), the Japanese government should consider raising the issue for discussion at a meeting of GATT.

CONCLUDING RECOMMENDATION TO JAPANESE BUSINESSES

Because of our grave concern with the inequitable nature of Unitary Taxation on our foreign investment activities, we, the members of the Committee on Unitary Taxation Issues in the Kansai area, earnestly appeal to the Japanese corporate decision makers to reconsider their foreign investment policies, and make no further direct investment in the States of the United States which impose or are imposing a Unitary Tax on a worldwide basis.

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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellees.

On Appeal From The Court Of Appeal Of
California, First Appellate District

MOTION OF THE UNION OF INDUSTRIES OF THE EUROPEAN COMMUNITY TO FILE BRIEF *AMICUS CURIAE*

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The Union of Industries of the European Community (Union des Industries de la Communaute Europeenne, hereafter "UNICE") respectfully moves this Court for leave to file in the case now pending, set for argument this fall, the brief *amicus curiae* that it previously filed in the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, Supreme Court No. 81-349, argued this spring. The interest of *amicus curiae* and the reasons for granting the motion are stated below.

UNICE is a confederation of the industrial federations of the ten member nations of the European Economic Community, and includes as associate members the eight national industrial federations of the European Free

Trade Association. Approximately two-thirds of all foreign direct investment in the United States is made through United States subsidiaries of European parent corporations, most of whom belong to a UNICE constituent federation. UNICE thus has an important, substantial, and direct interest in State taxation of its members' United States subsidiaries, such as that imposed by California's unitary tax at issue in this case.

A State's requirement of worldwide combined reporting of income, such as the requirement imposed by California, has a direct and adverse effect on those subsidiaries. However, this impact differs — both in degree and in kind — from the impact on the parties to this case, because those parties are all members of corporate groups with *domestic* parents. Corporate groups with *foreign* parents, such as members of the constituent federations of *amicus*, have a distinctly different treaty and constitutional status, and the application of a combined reporting requirement to them would raise additional and substantially different constitutional, treaty, and foreign policy issues. The brief to be filed by *amicus* identifies these issues, which are not presented by the record in this case or addressed by the courts below, and alerts the Court to the limited nature of the question presented for decision in this case.

Amicus has previously filed its brief *amicus curiae* in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, Supreme Court No. 81-349, pursuant to the consent of the parties to that case. The constitutional, treaty, and foreign policy issues discussed in that brief apply with equal force to the instant case, since the imposition of California's unitary tax on corporate groups with foreign parents raises the same issues as the application of Illinois' uni-

tary tax to such groups.* The points raised by *amicus* are not addressed by the parties in either case, however, because in both cases no party is a corporate group with a foreign parent.

Amicus therefore respectfully requests the Court to accept for filing in this case the UNICE *amicus* brief previously filed in *Chicago Bridge & Iron*. Forty copies of that brief are submitted herewith.

Respectfully submitted,

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*Obviously, the UNICE brief filed in the *Chicago Bridge & Iron Co.* case will still contain references to appellant Chicago Bridge & Iron Co. rather than to appellant the Container Corporation, and to the Illinois unitary tax rather than the California unitary tax. Other than these two obsolete references, however, the arguments and lega citations contained in the UNICE brief are fully apposite to, and define the limitations of, the issues posed by the *Container Corporation* case.

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Motion for Leave to File Brief *Amicus Curiae*, as well as the attached brief, was made on counsel for both parties on June 17, 1982, by depositing copies thereof in the United States mails, postage prepaid, addressed as follows:

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81-523

No. 81-349

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OCTOBER TERM, 1981

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QUESTION PRESENTED BY AMICUS CURIAE

When deciding the issue raised below of whether States may apply combined reporting requirements for tax purposes to international corporate groups with *domestic* parents, should this Court also decide the serious constitutional, treaty, and foreign policy issue not presented by this case: Whether States may apply such a tax regime to corporate groups with *foreign* parents?

TABLE OF CONTENTS

Page

INTEREST OF *AMICUS CURIAE* 1

SUMMARY OF ARGUMENT 3

ARGUMENT 4

I. A WORLDWIDE COMBINED REPORTING REQUIREMENT IS UNCONSTITUTIONAL WHEN APPLIED TO ANY GROUP OF CORPORATIONS WITH FOREIGN MEMBERS, INCLUDING MEMBERS OF *AMICUS* 4

II. ADDITIONAL GRAVE ISSUES, BOTH CONSTITUTIONAL AND TREATY-BASED, WOULD BE RAISED BY THE APPLICATION OF A COMBINED REPORTING REQUIREMENT TO A RELATED GROUP OF CORPORATIONS WITH A FOREIGN PARENT 5

A. The Constitutionality Of Combined Reporting Applied To Corporate Groups With Foreign Parents Is Particularly Suspect Because It Severely Affects Foreign Commerce 5

B. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Conflict With Treaties Between The United States And Foreign Nations 8

C. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Interfere With The Federal Government's Ability To Speak With One Voice On Foreign Policy And Would Invite Retaliatory Foreign Taxation 15

D. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Inevitably Lead To Impermissible International Double Taxation 21

III. BECAUSE THE RECORD DOES NOT PRESENT THE ISSUE OF THE CONSTITUTIONALITY OF COMBINED REPORTING APPLIED TO CORPORATE GROUPS WITH FOREIGN PARENTS, THE COURT SHOULD NOT DECIDE THAT ISSUE IN THIS CASE 23

CONCLUSION 24

TABLE OF AUTHORITIES

CASES: Page

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Comm'n*, 266 U.S. 271 (1924) 7

Caterpillar Tractor Co. v. *Lenckos*, 84 Ill.2d 102; 417 N.E.2d 1343 (1981) 7

Chy Lung v. *Freeman*, 92 U.S. 275 (1875) 23

Exxon Corp. v. *Department of Revenue*, 447 U.S. 207 (1980) 6

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) ..... *passim*

Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980) 6, 7

Moorman Mfg. Co. v. *Bair*, 437 U.S. 267 (1978) 11

Reeves, Inc. v. *Stake*, 447 U.S. 429 (1980) 6

Shell Petroleum N.V. v. *Graves, et al.*, No. C-81-4302 (N.D. Cal., filed November 4, 1981) 11

United States v. *Pink*, 315 U.S. 203 (1942) 20

U.S. CONSTITUTION:

Commerce Clause, art. 1, § 8 ..... *passim*

Due Process Clause, amend. 14, § 1 ..... 4, 11

STATUTES:

Section 482 of the Internal Revenue Code, 26 U.S.C. § 482 16

Section 891 of the Internal Revenue Code, 26 U.S.C. § 891 18

TREATIES:

Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, signed at The Hague, March 27, 1956, 8 U.S.T. 2043, T.I.A.S. No. 3942 8

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Table of Authorities Continued

Page

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MISCELLANEOUS:

H.R. 5076, 96th Cong., 1st Sess. (August 2, 1979) 7

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S. Ex. Rep. No. 96-5 (June 15, 1979) 17

State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, 96th Cong., 2d Sess. (1980) 7

127 Cong. Rec. S 14773 (daily ed., December 8, 1981) .. 14

Advisory Commission on Intergovernmental Relations, "State Taxation of Multinational and Multistate Corporations" (Washington, December 4, 1981) 14, 17, 20

Table of Authorities Continued

Page

MISCELLANEOUS:

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International Chamber of Commerce, Resolution (September 26, 1979) 14

Note Regarding the Unitary Basis of Taxation from the Government of the United Kingdom to the United States Government (March 25, 1980) 14

Notes Regarding State Unitary Taxation from the Governments of the Members of the European Economic Community to the United States Government (March 19, 1980 and October 30, 1981) 14

Organisation for Economic Co-operation and Development, 1977 Model Double Taxation Convention on Income and Capital 16

Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1 16

Treasury Department Tax Reform Option Paper No. VIII 20, 22

Treasury Department Proposed Model Income Tax Treaty (June 16, 1981) 16

UNICE, Press Release on Unitary Taxation (February 3, 1978) 14

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BRIEF OF THE UNION OF INDUSTRIES OF THE EUROPEAN COMMUNITY AS *AMICUS CURIAE*

INTEREST OF AMICUS CURIAE

The Union of Industries of the European Community (Union des Industries de la Communaute Europeenne, hereafter "UNICE") is a confederation of the industrial federations of the member nations of the European Economic Community.[1] The federations belonging to UNICE number among their members most of the major industrial corporations in these ten countries.

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[1] The member nations of the EEC are Belgium, Denmark, France, West Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom.

In addition, UNICE includes as associated members the industrial federations of the European Free Trade Association. [2]

A substantial majority of foreign direct investment in the United States comes from European sources, the overwhelming majority of which are multinational corporations belonging to a UNICE constituent federation. [3] In 1980, of the total foreign direct investment in the United States of $65.5 billion, European direct investment was approximately $43.5 billion, or about two-thirds of the total. [4] European enterprises own numerous subsidiaries that are engaged in many types of business in most of the States of the United States. Most of these enterprises are also engaged (through affiliated companies) in business activities in Europe and elsewhere throughout the world. UNICE (on behalf of its members) thus represents a large majority of all foreign direct investors in the United States, and has an important, substantial, and direct interest in State taxation of these business entities.

A State's requirement of worldwide combined reporting of income would have a direct and adverse impact on members of *amicus* with subsidiaries located in the United States. As demonstrated below, this impact is different from the impact on the parties to this case, since they are all corporate groups with *domestic* parents. Corporate groups with *foreign* parents, such as members of *amicus*, have a distinct treaty and constitutional status, and the application of the combined reporting requirement to them would raise additional and substantially different issues. *Amicus* files this brief [5] to identify these issues, which

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[2] The member nations of the EFTA are Austria, Cyprus, Finland, Norway, Portugal, Spain, Sweden, and Switzerland.

[3] Hereinafter, the term "member of *amicus*" means any corporation belonging to a federation that is directly or indirectly a member of UNICE.

[4] Bureau of Economic Analysis, United States Department of Commerce, 61 *Survey of Current Business*, p. 47 (August 1981, No. 8).

[5] Letters from all parties to this case consenting to the filing of briefs *amicus curiae* are on record with the Clerk of the Court.

were not covered by the record in this case or addressed by the courts below, and to alert the Court to the limited nature of the question presented for decision in this case.

SUMMARY OF ARGUMENT

I.

As urged by appellant, the Illinois combined reporting requirement is unconstitutional when applied to the foreign members of any corporate group, whether the parent of the group is domestic, such as the appellant, or foreign, such as members of the *amicus*.

II.

Application of State combined reporting requirements to corporate groups with *foreign* parents would raise grave constitutional, treaty and foreign policy issues beyond those raised by appellant:

State application of combined reporting requirements to corporate groups with foreign parents would conflict with existing United States treaties that prohibit burdensome, excessive, or unreasonable taxation. No State has the constitutional power to impose taxes on foreign corporations in a manner that conflicts with existing treaties signed by the United States.

State application of combined reporting requirements to corporate groups with foreign parents would violate generally accepted international tax principles, especially the "arm's-length" principle, interfere with the Federal government's power to negotiate treaties, and invite foreign retaliatory taxation. This direct State interference with the Federal government's exclusive authority to conduct foreign policy is prohibited by the Commerce Clause.

State application of combined reporting requirements to corporate groups with foreign parents would result in interna-

tional — not merely interstate — double taxation, which is unconstitutional under the Commerce Clause.

III.

Because no party to this suit is a corporate group with a foreign parent, these grave, complex and unique constitutional and treaty issues are not appropriately presented by the record in this case, nor were they addressed by the courts below. Should this Court conclude that State combined reporting is permissible for corporate groups with *domestic* parents, the absence of a proper record should cause the Court to reserve judgment on the separate issue of the constitutionality of extending these requirements to corporate groups with *foreign* parents.

ARGUMENT

I. A WORLDWIDE COMBINED REPORTING REQUIREMENT IS UNCONSTITUTIONAL WHEN APPLIED TO ANY GROUP OF CORPORATIONS WITH FOREIGN MEMBERS, INCLUDING MEMBERS OF AMICUS.

UNICE supports and endorses the position of the appellant that the imposition of an Illinois income tax on the apportioned combined worldwide business income of a group of related corporations that includes foreign corporations violates both the Commerce Clause and the Due Process Clause of the United States Constitution. This constitutional violation occurs whether the group's parent[6] is domiciled in the United States, as is appellant, or in a foreign country, as are members of *amicus*.

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[6] As used in this brief, the term "parent" means the corporation or corporations with ultimate voting control over the group of corporations whose "unitary" income is taxed by the State seeking to impose the combined reporting requirement. The term "group" means a group of corporations that has so-called unitary operations for purposes of State combined reporting (although *amicus* does not concede that the States' application of this principle conforms with constitutional, treaty, or tax law principles).

For the reasons stated in the appellant's principal brief, this Court should ban combined reporting requirements of a group of related corporations with foreign members regardless of the domicile of the parent.

II. ADDITIONAL GRAVE ISSUES, BOTH CONSTITUTIONAL AND TREATY-BASED, WOULD BE RAISED BY THE APPLICATION OF A COMBINED REPORTING REQUIREMENT TO A RELATED GROUP OF CORPORATIONS WITH A FOREIGN PARENT.

The appellant herein and the intervenors below are all *domestic* parents of groups of related corporations. Consequently, the validity of a tax on the combined worldwide business income of a group of related corporations with a *foreign* parent has not been adequately presented by this record. These foreign parents and the their foreign subsidiaries may have no operations and no presence in the taxing State or the United States, and may pay no Federal income tax, yet they are subjected to claims for taxes on their income under State combined reporting. UNICE is an association that includes such foreign parents and, as *amicus curiae*, demonstrates below the weighty additional constitutional issues that would be raised by the extension of the combined reporting requirement to corporate groups with foreign parents.

A. The Constitutionality Of Combined Reporting Applied To Corporate Groups With Foreign Parents Is Particularly Suspect Because It Severely Affects Foreign Commerce.

This Court has recognized that the Federal government's power over foreign commerce is greater than its power over interstate commerce, and that the reach of the States' taxing power is consequently more limited when it affects foreign commerce. In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), the Court held that, as between Federal power over foreign commerce and power over interstate commerce, "the scope of the foreign commerce power [is] the greater." 441

U.S. at 448. Similarly, in *Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980), the Court observed that ". . . Commerce Clause scrutiny may well be more rigorous when a [State] restraint on foreign commerce is alleged." 447 U.S. at 438 n.9. This Court's opinions have stressed that foreign policy is preeminently a national concern, in which the States may not interfere.

The Court's decision in *Japan Line, supra*, demonstrates the severe limits this principle places on State taxing power. The State of California sought to levy a property tax on an apportioned part of the value of shipping containers used in international trade. The legal situs of the containers was Japan, which was entitled to and did tax their full value. California argued that its tax applied only to a properly allocable in-state portion of the containers' value, and that the Federal power over foreign commerce was therefore not affected. The Court rejected this argument because of Japan's recognized power to tax the full value of the containers, including California's purported "share;" the Court noted that California's argument "may have force in the interstate commerce context," 441 U.S. at 454, but not in the context of foreign commerce.

Although *Japan Line* involved an *ad valorem* property tax, not an income tax, the constitutional principles and policies enunciated therein are equally applicable to an income tax. When the issue is properly joined before this Court, the principle of *Japan Line* might be held to prohibit a State income tax on the unitary income of a foreign-owned corporate group, because that income is taxable in the country of the parent's domicile.[7]

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[7] This Court has yet to consider the impact of the Commerce Clause on such a tax. The two successor cases to *Japan Line, Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), and *Exxon Corp.* v. *Department of Revenue*, 447 U.S. 207 (1980), both dealt with the imposition of State income tax combined reporting requirements on the *domestic* parent of a worldwide operation; the issue in each case was the proper method of

Such a result makes sense in light of the serious treaty and foreign policy problems, discussed below, that would inevitably result from the attempted expansion of State income taxation. Members of both the legislative [8] and executive [9] branches of the Federal government have already expressed their support for precluding State application of combined reporting to foreign-owned corporate groups, in effect endorsing the principles and policies that would underlie the application of the *Japan Line* rationale to State income taxes.

In any event, *Japan Line* clearly requires that combined reporting be scrutinized more closely when applied to corporate

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apportioning among the States what was conceded to be "income to the parent," *Mobil Oil Corp., supra*, 445 U.S. at 440, and did not involve a question of double taxation at the international level. *Id.* at 447-48. Moreover, the Illinois Supreme Court, distinguishing *Japan Line* in its opinion below, did not purport to consider the effect of combined reporting on a foreign-based multinational corporation. *Caterpillar Tractor Co.* v. *Lenckos*, 84 Ill. 2d 102, 417 N.E.2d 1343, 1353-54 (1981).

The Court's decision in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271 (1924), cited in *Mobil Oil Corp., supra*, also involved a different question, since it concerned a single corporation whose branch office operated within the taxing State.

[8] The *Recommendation* of the Task Force on Foreign Source Income, House Committee on Ways and Means, 95th Cong., 1st Sess. (Comm. Print 1977), proposed that foreign-based parent companies be exempted from State income tax combined reporting requirements, and various legislative methods of implementing this proposal have been explored. *See*, e.g., H.R. 5076, 96th Cong., 1st Sess. (August 2, 1979); S. 983, 96th Cong., 1st Sess. (April 23, 1979); S. 1688, 96th Cong., 1st Sess. (August 3, 1979); H.R. 1983, 97th Cong., 1st Sess. (February 23, 1981); S. 655, 97th Cong., 1st Sess. (March 10, 1981).

[9] *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance*, 96th Cong., 2d Sess. 38 (1980) (Testimony of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

groups with *foreign* parents than when applied to groups with *domestic* parents. The instant case requires only the latter, less stringent examination.

B. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Conflict With Treaties Between The United States And Foreign Nations.

1. Treaties prohibit States from subjecting foreign corporations to burdensome, excessive, or discriminatory taxation.

The United States is currently a party to some 28 treaties of friendship, commerce, and navigation with foreign nations, and to tax conventions with approximately 59 countries. These treaties and conventions generally contain provisions which, *inter alia*, prohibit discrimination against foreign companies or United States companies owned by foreigners and also, in some cases, restrict taxation to income which is related to or allocable to activities within the United States. [10]

The treaties with the Netherlands [11] are an excellent example. The Netherlands FCN Treaty requires that State taxation meet general standards of reasonableness and nondiscrimination.

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[10] The United States presently has tax conventions with all nations of the European Economic Community and all nations in the European Free Trade Association except Cyprus, Spain, and Portugal. The United States has FCN or similar treaties with all nations of the European Economic Community except the United Kingdom, and with four members of the European Free Trade Association: Austria, Finland, Norway and Switzerland.

[11] Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, signed at The Hague, March 27, 1956, 8 U.S.T. 2043, T.I.A.S. No. 3942 (the "Netherlands FCN Treaty"); Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, signed at Washington, April 29, 1948, 6 U.S.T. 3696, T.I.A.S. No. 1855, as amended by the Supplementary Convention, signed at Washington, December 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051 (the "Netherlands Tax Convention").

State taxing authorities must "at all times accord fair and equitable treatment to the nationals and companies of the [Netherlands], and to their property, enterprises and other interests," Art. I, § 1, and are barred from taking "unreasonable or discriminatory measures that would impair the rights or interests" in the United States of Netherlands companies or their subsidiaries. Art. VI, § 3. The Netherlands Tax Convention protects a Netherlands company from taxation of its interests in the United States that is more burdensome than the taxes imposed on a corporation of the United States, the capital of which is wholly owned by citizens or corporations of the United States. Art. XXV, §§ 4 and 5. The Netherlands FCN Treaty prohibits States from imposing taxes more burdensome than those borne by nationals of "any third country." Art. XI, § 3. [12] Finally, the Netherlands FCN Treaty prohibits U.S. taxing jurisdictions from imposing or applying any tax "upon any income, capital, or other basis in excess of that reasonably allocable or apportionable" to the taxing jurisdiction. Art. XI, § 4. Similar provisions appear in other treaties, such as those with the Republic of China [13] and, as noted above, France. [14]

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[12] This obligation imposes more stringent limitations on State taxation by incorporating other treaty restrictions; for example, the Convention of Establishment between the United States of America and France, signed at Paris, November 25, 1959, 11 U.S.T. 2398, T.I.A.S. No. 4625. Article IX limits State taxation of French companies to income "directly related to their activities within those territories."

[13] Treaty of Friendship, Commerce and Navigation between the United States of America and the Republic of China, signed at Nanking, November 4, 1946, 63 Stat. 1299, T.I.A.S. No. 1871, continued in force, 22 U.S.C. § 3303(c), Art. X.

[14] Convention between the United States of America and the French Republic with Respect to Taxes on Income and Property, signed at Paris, July 28, 1967, 19 U.S.T. 5280, T.I.A.S. No. 6518, Art. XXIV; Convention of Establishment between the United States of America and France, *supra*, Art. IX.

As explained below, State combined worldwide reporting requirements subject United States subsidiaries of foreign corporations to taxes and compliance procedures that are unreasonable within the meaning of the treaties and more burdensome than those imposed on United States companies. They impose taxes on income in excess of that reasonably allocable to the State under generally accepted international principles. State application of combined worldwide reporting to a group of corporations with a foreign parent, therefore, conflicts with existing treaties. Under our Federal system, no State has the constitutional power to act in a manner which violates United States treaty commitments.

2. The combined reporting allocation formulas, when applied beyond the homogeneous economy of the United States, distort income and subject foreign parents to excessive taxation, in violation of treaties.

The combined reporting requirement employs an apportionment formula that assigns to the taxing State a portion of the total income of the taxpayer's "unitary business," usually based on factors such as property, payroll, and sales. Implicit in these formulas (and a prerequisite to their validity) is the assumption that the economic environment in which these factors exist is roughly homogeneous throughout the entire area of the corporation's operations. Such an assumption may be reasonable in the case of a domestic parent whose corporate group carries on most of its business within the United States.

When the group has extensive operations in other countries (as most foreign-owned groups do), however, the apportionment formulas can produce seriously distorted results. Differences in wage rates, raw material prices, insurance, and risk will generate "in-state" income figures that bear no rational relation to the proportion of the business actually conducted within the taxing State's borders. Recently, for example, a State taxing authority apportioned to one of over 900 worldwide

subsidiaries of a member of *amicus* an income of $46,000,000 over a four-year period, despite the fact that the subsidiary itself had losses of some $390,000,000 during the same period.[15] This result shows that the combined reporting requirements can produce quixotic taxation when applied to groups with foreign parents.

A foreign parent domiciled in an FCN Treaty country can justly assert that the State tax is being applied to income in excess of that reasonably allocable or apportionable to the taxing State, in violation of Federal treaty obligations.[16] In addition, both a foreign parent and a domestic parent can properly assert, as the appellant in this case has done, that such taxation violates the Due Process Clause of the United States Constitution.

3. Conflicting interpretations of combined reporting requirements by States would result in unreasonable and discriminatory treatment of foreign corporations in violation of treaties.

The unitary method is a way of crudely approximating the portion of a multistate corporation's income that is attributable to the taxing State. Because the result will in any case be only a very rough estimate, States have been allowed, within broad limitations, to devise their own individual combined reporting requirements and apportionment formulas. *Moorman Mfg. Co.*

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[15] This conduct by the State taxing authority is being challenged in a Federal district court as violative of treaties between the United States and the Netherlands, general principles of international law, and the United States Constitution. *Shell Petroleum N.V.* v. *Graves et al.*, No. C-81-4302 (N.D. Cal. filed November 4, 1981).

[16] There will be numerous combinations of State tax law, FCN treaties and tax conventions. The nature and severity of the constitutional issue will therefore depend on the relationship of the specific provisions of the State tax law to the provisions of the applicable FCN treaty and tax convention.

v. *Bair*, 437 U.S. 267 (1978). These variations in State methods can result in inexact apportionment.

While a potential for inexactitude may be tolerable under our broad constitutional principles of Federalism, it is intolerable in foreign affairs. Any meaningful inexactitude is inconsistent with treaty provisions that forbid State taxing authorities from taking "unreasonable or discriminatory measures" with respect to foreign corporations, and from taxing income and profits from transactions that arise outside the United States. [17]

4. The combined reporting requirement imposes on a foreign parent more burdensome tax obligations than those imposed on domestic companies, in violation of treaties.

A foreign parent of a worldwide group of corporations ordinarily keeps its books and records using the accounting systems and currency of its country of domicile. (Indeed, it is often required to do so by the laws of that country.) Compliance with a State combined reporting requirement would present a foreign parent with immense and costly administrative problems that a domestic corporation operating under the United States Federal system of taxation would never face. By virtue of its domicile, a domestic parent already complies with United States tax reporting requirements. In contrast, a foreign parent would be compelled to recompute its entire worldwide income according to accepted United States accounting principles, even though these might (and often do) differ drastically from those required by its country of domicile. It would have to convert its worldwide income into United States dollars, taking into account frequent wide fluctuations in the exchange rates of numerous foreign currencies. [18]

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[17] *Cf. Japan Line, Ltd.* v. *United States*, *supra*, 441 U.S. at 456, discussed below at 21.

[18] Indeed, since many multinationals plan their transactions with currency exchange fluctuations in mind, major corporate strategy decisions would be influenced by the necessity of ultimately converting corporate records into United States dollars for State tax purposes.

For example, a subsidiary of a United States corporation operating in France would ordinarily maintain its records in French francs. The francs would have to be converted into the value of United States dollars in reporting its earnings for United States tax purposes, and there would likely be accounting adjustments because of different accounting principles. But this would end the matter. A subsidiary of a Netherlands company operating in France would also maintain its records in francs, and would have to convert the francs into guilders in reporting its earnings to the Netherlands authorities. Thereafter, however, the Netherlands parent (if it also had a United States subsidiary) would have to convert the guilders to United States dollars (and quite possibly make accounting adjustments) to satisfy the requirements of a State that employed the worldwide unitary system of reporting. If the Netherlands parent has many subsidiaries operating in numerous countries, it and its worldwide subsidiaries would have to go through the whole process of multiple currency and accounting adjustments for each entity. These costly and burdensome requirements would be imposed even on a foreign group whose United States operations represented only a minuscule portion of its total activity.

Further complications are possible. Different States may use different methods of applying combined reporting apportionment formulas, and may require differing methods of accounting for exchange rate fluctuations and other transactions. Thus, a foreign parent corporation could be forced to undertake this process separately for each State in which it operates.

These burdens discriminate against, and "impair the rights or interests of," foreign parent companies. Domestic parents' burdens are not nearly so heavy. Because State tax requirements subject the treaty-protected corporations to more burdensome obligations with respect to taxes than those imposed on domestic parents, they violate the FCN treaties.

* * *

The treaty problems described above are weighty and troublesome, and are viewed with rapidly increasing concern by the United States' treaty partners. On March 19, 1980, and again on October 30, 1981, the ten members of the European Economic Community joined in a *demarche* to the State Department, strongly condemning the States' application of the unitary system to corporations domiciled in their countries and urging a swift Federal remedy.[19] On March 25, 1980, the British Government delivered a note to the State Department summarizing the objections of the United Kingdom to State unitary income taxation.[20] The International Chamber of Commerce issued a Resolution opposing the unitary method on September 26, 1979.[21] *Amicus*, representing multinational corporations of almost all of the major United States trading partners, has publicly stated its firm opposition to the unitary method in an international press release dated February 3, 1976.[22] This question is already a major issue in United States foreign relations with its treaty partners.

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[19] Advisory Commission on Intergovernmental Relations (hereafter ACIR), "State Taxation of Multinational and Multistate Corporations" (Washington, December 4, 1981), at 12-14; 127 Cong. Rec. S 14773 (daily ed., December 8, 1981).

[20] Note Regarding the Unitary Basis of Taxation from the Government of the United Kingdom to the United States Government (March 25, 1980), Appellant's Appendix, I-14-16.

[21] International Chamber of Commerce, Resolution (Doc. No. 180/195 Or. Rev., Sept. 26, 1979), Appellant's Appendix, I-47-48.

[22] UNICE Press Release on Unitary Taxation (February 3, 1976). This press release noted with regret that United States political subdivisions might abandon the internationally recognized system of taxation based on the arm's-length principle and instead adopt a unitary based system: "The fact is that the unitary tax system does not lead to taxation on an equitable basis, as it can easily result in double taxation which it is virtually impossible to cure where international operations are involved. . . . UNICE therefore

Because no party to this case is a member of a corporate group with a foreign parent, this complex treaty issue was not covered in the record below, not raised by the parties, and not addressed by the Illinois courts. It should be expressly reserved for a later decision in an appropriate case.

C. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Interfere With The Federal Government's Ability To Speak With One Voice On foreign Policy And Would Invite Retaliatory Foreign Taxation.

When inquiring into a State tax that directly affects foreign (rather than interstate) commerce, a court must examine whether the tax prevents the Federal government from "speak-[ing] with one voice when regulating commercial relations with foreign governments." *Japan Line, supra*, 441 U.S. at 449. If it does, the tax is unconstitutional under the Commerce Clause. *Id.*

Application of the combined reporting requirement to a United States corporate group that includes foreign subsidiaries may substantially interfere with the Federal government's power to conduct its foreign commercial relations. The interference is far worse, however, when the group has a *foreign* parent. The extension of combined reporting to such a group therefore raises substantial constitutional issues.

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takes the view that as regards the determination of taxable incomes of groups of companies, political subdivisions of contracting states should adopt the universally recognized method based on the arm's length principle."

1. The Federal government would be prevented from harmonizing its foreign policy with generally accepted principles of international taxation, and its ability to negotiate advantageous treaties and accords would be impaired.

There is an existing broad consensus among the international community that the so-called "arm's-length" method[23] of apportioning a multinational taxpayer's income among taxing jurisdictions is the only acceptable approach to the taxation of multinational corporate groups.[24] The arm's-length method is used both by the United States in determining the Federal tax liability of foreign entities, and by foreign nations in determining the tax liability of subsidiaries of United States corporations operating within their borders. Among the developed nations, it appears that certain States in this country are the only major income taxing jurisdictions that have rejected the arm's-length method and adopted the far more intrusive and extensive combined reporting system.

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[23] Under the "arm's-length" method, the profits earned by a taxpayer involving transactions with related entities are determined as though the terms of the transactions were those that would have been agreed on between unrelated parties engaged in the same transactions. This method is the same as that prescribed by section 482 of the Internal Revenue Code, 26 U.S.C. § 482, for Federal tax purposes, and is intended to prevent artificial shifting of income.

[24] *See, e.g.*, Committee on Fiscal Affairs, Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris 1979), at 8-9; Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L. L.J. 1, 53-57, 83-84, 121-22 (1978); the arm's-length method is also prescribed by the OECD Model Convention on Double Taxation as well as the Department of the Treasury's Proposed Model Income Tax Treaty. Organisation for Economic Co-operation and Development, 1977 Model Double Taxation Convention on Income and Capital, Arts. 7 and 9, *reprinted in* 1 CCH Tax Treaties ¶ 151; United States Department of the Treasury, Proposed Model Income Tax Treaty (June 16, 1981), *reprinted in* 1 CCH Tax Treaties ¶ 158.

These States' departure from this broad consensus has interfered with the Federal government's conduct of its foreign affairs and damaged the Nation's standing in the international community. As noted above, some foreign nations consider the application of the combined reporting requirement to their domiciliaries a violation of United States treaty commitments. Clearly, a few States' unilateral actions have prevented the Federal government from "speaking with one voice" on foreign policy matters.

The unitary tax system has also interfered with treaty negotiations, an exclusively Federal domain. A provision dealing with unitary State taxation of corporate groups with foreign parents was a major sticking-point in the negotiation of the recent Convention between the United States of America and the United Kingdom, signed at Washington, December 31, 1975, T.I.A.S. No. 9682. [25] In view of the widespread opposition of foreign nations to State unitary taxation of foreign parents, the issue will in all likelihood be raised with frequency and vigor in future negotiations. [26]

State imposition of combined reporting requirements on foreign based parents necessarily results in a serious State intrusion into our Nation's foreign policy and raises fundamental constitutional issues that cannot be resolved on the record in this case.

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[25] The provision was ultimately dropped, but only on the understanding that a legislative solution to the problem would be forthcoming. *See* S. Ex. Rep. No. 96-5 (June 15, 1979), at 6. As noted above, the United Kingdom subsequently formally protested State unitary income taxation.

[26] *See also* ACIR, "State Taxation of Multinational and Multistate Corporations," *supra*, at 18-19.

2. The United States would face serious risks of retaliatory taxation imposed by other nations on foreign subsidiaries of United States corporations.

As foreign governments become increasingly offended by what they perceive to be unfair or oppressive tax treatment of their corporations by States, the risk of a retaliatory tax on foreign subsidiaries or operations of United States corporations will grow. Foreign nations could find precedent, if precedent were needed, for retaliatory taxation in section 891 of our Internal Revenue Code, which grants the President the right to double the rate of tax on citizens of any foreign nation that subjects United States citizens to a discriminatory or extraterritorial tax.

Any retaliatory tax imposed by a foreign government would almost certainly not be directed only at corporations owned by domiciliaries of the offending States. Rather, the United States as a whole would suffer the international consequences of the unilateral action of a few of its States. As this Court noted in *Japan Line, supra*, this is precisely the type of State interference with foreign affairs prohibited by the Constitution:

> "If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States follow the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce." 441 U.S. at 450-451 (footnotes omitted).

A decision to run such nationwide risks of foreign tax retaliation must be left to the Federal government, not to State taxing authorities whose responsibilities are limited to generating State revenue. Otherwise there would be created a constitutionally impermissible division between the *power* to take actions seriously affecting foreign commerce and the *responsibility* for the results of those actions.

3. The Federal government's power to negotiate mutual restrictions on access to confidential governmental information would be diminished.

Every sovereign nation has the right to control foreign access to information about its economic policies, national defense, and other sensitive subjects. As part of that control, nations ordinarily contract for delicate defense or research projects only with domiciliary corporations. Foreign access to such information is thereby limited.

For a United States parent of a worldwide group, combined reporting does not affect this confidentiality. The taxing authority requiring information about the group's activities is itself a United States entity, and any conflicts that develop can be resolved, if necessary, by this Court.

A foreign parent, however, faces a different problem. From its viewpoint, a foreign nation's taxing authorities are requiring detailed information concerning matters that the corporation is legally and patriotically required to withhold. Furthermore, there is no available forum with jurisdiction over all parties. Foreign nations would understandably resent these State intrusions into their sovereign secrets, and the Federal government's power to negotiate and enforce restrictions on foreign access to its own confidential information would be impaired. Under our Constitution, a State does not have the power to create these disruptions in national policy.

4. The Federal government's attempts to attract, discourage, or regulate foreign investment in the United States would be impeded.

The problems described above discourage foreign investment in the United States. Foreign-based corporate groups become less willing to locate capital in this country, even for limited purposes, as State tax and compliance burdens grow, especially those that affect foreign parents more heavily than domestic parents. Recent treaty negotiations with the United Kingdom and Canada have already revealed an increased concern on the part of foreign governments over the effect of combined reporting on their policies regarding investment in the United States.[27]

The Commerce Clause lodges in the Federal government alone the power to encourage, discourage, or otherwise regulate foreign investment. To the extent combined reporting requirements intrude into this sphere, they are inconsistent with the Commerce Clause, and constitutionally invalid.

* * *

In our Federal system, authority to conduct relations with foreign nations has been given to those responsible for the welfare of the Nation as a whole, not to those whose sole concern is levying and collecting local taxes. As this Court has stated:

> "These are delicate matters. If state action could defeat or alter our foreign policy, serious consequences might ensue. The nation as a whole would be held to answer if a State created difficulties with a foreign power." *United States* v. *Pink*, 315 U.S. 203, 232 (1942).

Extending combined reporting requirements to corporate groups with foreign parents would create just such difficulties.

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[27] Treasury Department Tax Reform Option Paper No. VIII, *excerpted in relevant part in* Appellant's Appendix, Section F; ACIR, "State Taxation of Multinational and Multistate Corporations," *supra*, at 19.

The States' encroachment on the areas of exclusive Federal jurisdiction described above has already been substantial, and has given rise to considerable Federal concern. Several pieces of legislation have been proposed. [28] The Treasury Department, the House Ways and Means Committee, and the Advisory Committee on Intergovernmental Relations have all urged that Federal action be taken to limit the States' intrusion into foreign affairs. This is a complex and delicate issue that must, at the appropriate time, be addressed directly and at length.

However, because no foreign-based corporate group is a party to this case, this constitutional issue was not addressed below, and there is no record to support a reasoned decision concerning it. It is clear, however, that the practice would severely restrict the ability of the Federal government to "speak with one voice" in matters of foreign policy and interfere with the Nation's conduct of foreign affairs.

D. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Inevitably Lead To Impermissible International Double Taxation.

This Court has held that a State tax that, notwithstanding apportionment, "creates a substantial risk of international multiple taxation . . . is unconstitutional under the Commerce Clause." *Japan Line, supra,* 441 U.S. at 451. This holding reflects the general policy that

> "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Japan Line, supra,* 441 U.S. at 456.

The reason for such a principle is clear. As this Court explained,

> "[N]either this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign

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[28] *See* note 8, *supra.*

> sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that 'multiple burdens logically cannot occur,' the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Japan Line*, *supra*, at 447-48 (footnotes and citations omitted).

This Court is available as a final arbiter of any conflicts that may arise among the several States with respect to the proper apportionment of a taxpayer's income. But no tribunal can resolve similar conflicts between a State and a foreign nation. Rather, such conflicts must be resolved by international negotiations that may constitutionally be conducted only by the Federal government.

A Treasury Department study of the States' experience with unitary tax concluded that it results in international double taxation of income because it apportions income on a basis totally different from the arm's-length method agreed to by the major developed nations.[29] Predictably, State tax administrators support the unitary system because it generally brings in higher revenues. When it does so, however, a State taxes income outside of its legitimate jurisdiction, income which has been ceded for taxation to other jurisdictions by treaty and generally accepted principles of international tax law.

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[29] Treasury Department Tax Reform Option Paper No. VIII, *supra*.

Accordingly, a State's taxation of income that may result in double taxation impermissibly encroaches on the power of the Federal government and is a violation of the foreign Commerce Clause of the Constitution. The States' power ends where the Federal government's power begins; indeed, as this Court has stated:

> "If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung* v. *Freeman*, 92 U.S. 275, 280 (1875).

The combined worldwide reporting requirement threatens to do just that, and therefore is constitutionally impermissible.

III. BECAUSE THE RECORD DOES NOT PRESENT THE ISSUE OF THE CONSTITUTIONALITY OF COMBINED REPORTING APPLIED TO CORPORATE GROUPS WITH FOREIGN PARENTS, THE COURT SHOULD NOT DECIDE THAT ISSUE IN THIS CASE.

The record in this case provides abundant support for a conclusion that State combined reporting requirements may not constitutionally be imposed on *any* group of related corporations with foreign members, irrespective of the domicile of the group's parent. If the Court finds for appellant, corporate groups with foreign parents (such as members of *amicus*) will not be subject to State combined reporting requirements, and none of the additional issues described above need ever be addressed.

However, if the Court should conclude that the worldwide combined reporting requirement is permissible for a corporate group with a *domestic* parent, the weighty additional issues that arise when such a group has a *foreign* parent should not be decided in this case, since they have not been adequately addressed by the parties or reflected in the record. These issues should be determined only after a full record has been developed and arguments based on that record are squarely presented for decision.

CONCLUSION

For the reasons set forth above, the Court should hold for the appellant. If the Court nevertheless upholds the validity of imposing the combined reporting requirement on the appellant, the validity of extending that requirement to corporate groups with foreign parents should be expressly reserved for later decision.

Respectfully submitted,

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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From the Court Of Appeal of the State of California, First Appellate District

BRIEF OF AMICUS CURIAE STATE OF VERMONT IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

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TABLE OF CONTENTS

Page

Table of Authorities ii

Statement of Interest 1

Introduction and Summary of Argument 3

Argument 5

A. California's Tax On A Fairly Apportioned Share of the Net Income Derived From A Unitary Business Is Not A Tax On "Foreign" Income 5

B. California's Apportioned Tax Does Not Result In Multiple Taxation 8

C. The Commerce Clause Permits Some Overlapping In Taxation 9

D. The Court's Decision In *Japan Line, Ltd.* Has No Application To This Case 10

E. This Court Has The Power To Prevent Excessive Taxation Of Income Should It Arise 13

Conclusion 14

TABLE OF AUTHORITIES

CASES	PAGE(S)
Asarco, Inc. v. Idaho State Tax Commission, ..U.S..., 50 U.S.L.W. 4962 (U.S. June 29, 1982)	6
Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924)	4, 6
Butler Brothers v. McColgan, 315 U.S. 501 (1942)	7
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)	10
Exxor Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980)	6, 8, 11
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)	4, 9, 10, 11, 12
Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980)	1, 5, 6, 11, 13
Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978)	8, 9
Norfolk & Western Railway v. North Carolina, 297 U.S. 682 (1936)	4
Northwestern Cement Co. v. Minnesota, 358 U.S. 450 (1959)	4, 8
Washington Revenue Department v. Stevedoring Association, 435 U.S. 734 (1978)	3

Page

OTHER AUTHORITIES

COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS (Sept. 30, 1981) 2

HOUSE COMM. ON WAYS AND MEANS, H.R. Doc. No. 788, 95th Cong., 1st Sess., RECOMMENDATION OF THE TASK FORCE ON FOREIGN SOURCE INCOME (Comm. Print 1977) 2

Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970) 7

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BRIEF OF AMICUS CURIAE STATE OF VERMONT IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

STATEMENT OF INTEREST

At stake for Vermont is a substantial reduction in tax revenues. A decision in support of Container Corporation of America ("Container") would overrule this Court's decision in favor of Vermont in *Mobil Oil Corporation* v. *Commissioner of Taxes,* 445 U.S. 425 (1980), by holding that income of a foreign subsidiary can be excluded from a parent company's apportionable tax base solely because the subsidiary income is characterized as having a foreign source.

Furthermore, acceptance of the position advocated by Container would require Vermont to rely upon what is commonly referred to as the "arm's-length standard," a method of accounting that requires intercompany transactions to be priced like transactions between unrelated parties. This method is expensive and imposes significant administrative burdens on both taxpayers and tax administrators. COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS 52-53 (Sept. 30, 1981); HOUSE COMM. ON WAYS AND MEANS, H.R. DOC. No. 788, 95th Cong., 1st Sess., RECOMMENDATION OF THE TASK FORCE ON FOREIGN SOURCE INCOME (Comm. Print 1977). It is virtually impossible for a small state like Vermont to reconstruct intercompany transactions on a worldwide arm's-length basis.

Because Vermont would be unable to enforce the arm's-length method of accounting, it would be unable to guard against misallocation of income by multinational corporations operating in Vermont. A decision that allocation of foreign source income is constitutionally required would force Vermont to discriminate in its tax enforcement policies against wholly domestic corporations, which would report their income using only formulary accounting. As a result, a real danger exists that these corporations would bear a disproportionate share of the tax burden in Vermont.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Commerce Clause does not prohibit a state from taxing the net income of a corporation solely because the income has a foreign source. A state may constitutionally tax the combined net income of a domestic corporation and its foreign unitary subsidiaries if the income is fairly apportioned to reflect the business' activities within the taxing jurisdiction.

An inherent conflict exists between the revenue needs of the states and the national interest in encouraging the free flow of commerce among the states and between this country and other countries. Recognizing this conflict, this Court has stated that

> [A] State has a significant interest in exacting from interstate commerce its fair share of the cost of state government. 430 U.S., at 288. Accord, *Colonial Pipeline Co.* v. *Traigle*, 421 U.S., at 108; *Western Live Stock* v. *Bureau of Revenue*, 303 U.S., at 254. All tax burdens do not impermissibly impede interstate commerce. The Commerce Clause balance tips against the tax only when it unfairly burdens commerce by exacting more than a just share from the interstate activity.

Washington Revenue Department v. Stevedoring Association, 435 U.S. 734, 748 (1978). State taxes on net income derived from interstate or foreign commerce have been held constitutional when they are fairly apportioned to reflect business activities in the taxing jurisdiction. *E.g.*,

Northwestern Cement Co. v. *Minnesota*, 358 U.S. 450 (1959); *Norfolk & Western Railway* v. *North Carolina*, 297 U.S. 682 (1936); *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

Container has argued that worldwide apportionment of net income derived from a unitary business violates the Commerce Clause because it results in multiple taxation of foreign source income. In Container's view, the Commerce Clause requires allocation of foreign source income, rather than apportionment. Container's argument rests on a series of erroneous premises:

(1) that California's efforts to tax a fairly apportioned share of a business' net income should be treated as an attempt to tax foreign income;

(2) that California's tax results in multiple taxation;

(3) that the Commerce Clause prohibits overlapping in taxation arising from differences in accounting methods among nations;

(4) that this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles* requires allocation of foreign source income; and

(5) that the Court would be without power to prevent excessive taxation of income derived from foreign commerce should it arise.

ARGUMENT

There is no Commerce Clause bar to a fairly apportioned tax on the combined net income of a domestic corporation and its foreign unitary subsidiaries.

A. California's tax on a fairly apportioned share of the net income derived from a unitary business is not a tax on "foreign" income.

Two basic accounting methods are employed by tax officials to ensure that income is taxed only in the jurisdiction where it is earned. One method, separate accounting, attempts to identify the sources of net income generated by a business and to allocate to each situs the income earned in that situs. The other method, unitary apportionment, attempts to allocate net income to each locality in which a business operates in the proportion that the business activities conducted by the corporation in that locality bears to the business activities conducted by the corporation in all localities.

This Court has stated that separate accounting is not constitutionally required. In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), the Court rejected the contention that the source of income earned by a unitary business must be ascertained by separate geographic accounting.

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and

> economies of scale. *Butler Bros.* v. *McColgan*, 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

445 U.S. at 438.

As the Court stated in *Mobil*,

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle.

445 U.S. at 439. This statement was repeated by the Court in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980) and *Asarco, Inc. v. Idaho State Tax Commission*, . . . U.S. . . . , 50 U.S.L.W. 4962 (U.S. June 29, 1982). In keeping with these decisions, a state may constitutionally tax the entire net income of a corporation and its subsidiaries, foreign and domestic, if the corporations form a unitary business and the net income is fairly apportioned to reflect business activities within the taxing jurisdiction.

The Court recognized that foreign source income may be included in an apportioned tax base in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924). The Court concluded that although a British corporation had attributed its income entirely to foreign

sources for federal income tax purposes, New York could tax that allegedly "foreign" income on a fairly apportioned basis because the corporation carried on sales activities there as part of its unitary business. The same conclusion should be drawn in this case.

California's taxing plan reaches only income that fairly represents the extent of the business activities of Container and its unitary subsidiaries within the State of California. *Butler Brothers v. McColgan*, 315 U.S. 501, 506 (1942). California has not gone beyond its borders to tax the entire net income of the corporation or the separate income of its subsidiaries. The fact that earnings of Container's foreign subsidiaries are included in California's apportionable tax base does not make the tax one on foreign commerce.

> [F]oreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment — in the case of a multistate business — involve the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the instate income taxable by the particular state.

Rudolph, *State Taxation of Interstate Business: The*

Unitary Business Concept and Affiliated Corporate Groups, 25 TAX L. REV. 171, 205 (1970).

B. California's apportioned tax does not result in multiple taxation.

The Court has rejected speculation on the question of multiple taxation, requiring instead actual proof of duplicative taxation. *E.g., Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228-29 (1980); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 276 (1978); *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450, 462 (1959). Absent clear and cogent evidence to the contrary, an apportioned tax is recognized as avoiding multiple taxation.

> The apportioned tax is designed to meet this very requirement and "to prevent the levying of such taxes as will discriminate against or prohibit the interstate activities or will place the interstate commerce at a disadvantage, relative to local commerce." *Id.*, at 670. Logically it is impossible, when the tax is fairly apportioned, to have the same income taxed twice.

Northwestern Cement Co. v. Minnesota, 358 U.S. 450, 462 (1959).

Container has attempted to establish that multiple taxation occurs under California's tax by comparing the results of separate accounting with the results of California's apportionment formula. The actual comparison used failed to account for variations in the definition of

"income" for tax purposes from jurisdiction to jurisdiction. Absent proof that the taxing jurisdictions employed the same tax definition of "income," a comparison of accounting methods does not show that multiple taxation in fact occurred.

C. The Commerce Clause permits some overlapping in taxation.

Even if Container were able to establish that multiple taxation in fact had occurred, this Court has never invalidated a properly apportioned state income tax solely because some overlap in taxation arose out of differences in accounting methods employed among taxing jurisdictions. In *Moorman Manufacturing Co. v. Bair*, 437 U.S. at 278 (1978), the Court noted that some risk of duplicative taxation exists whenever the states in which a corporation does business do not follow identical rules for the division of income. The Court nevertheless refused to legislate uniform rules for the division of income. Again in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 455 (1979), the Court stated that mathematical imprecision in apportionment formulae does not invalidate a fair apportionment scheme.

> [T]his Court consistently had held that the Commerce Clause "does not call for mathematical exactness nor for the rigid application of a particular formula; only if the resulting valuation is palpably excessive will it be set aside." (citations omitted).

A decision that a fairly apportioned net income tax may not be imposed because of differences in accounting methods employed among nations would allow corpora-

tions to avoid their fair share of taxes without justification. Because the Court would be without jurisdiction to regulate the taxing schemes of foreign countries, a requirement that California's fair apportionment formula must yield to the allocation made by a foreign government would render California impotent to exact from multinational commerce its share of the cost of government.

The appropriate question for this Court is whether California's tax scheme results in a fair allocation of the tax burden among all states and countries in which a unitary business operates, not whether mathematical precision in taxation is attained. As the Court has done in the case of multistate businesses, the Court should sustain state income taxes on multinational corporations provided the taxes meet the four requirements described in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Court should sustain taxes, like California's, that are applied to activities with a substantial nexus with the state, that are fairly apportioned, that do not discriminate against foreign commerce, and that are fairly related to the services provided by the state. 430 U.S. at 279.

D. The Court's decision in *Japan Line, Ltd.* has no application to this case.

In the context of ad valorem taxation of instrumentalities of foreign commerce, the Court imposed two tests in addition to those articulated in *Complete Auto Transit. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). The Court required that the tax not result in multiple taxation of the instrumentalities of foreign commerce and that it not prevent the nation from "speaking

with one voice" when regulating foreign commerce. 441 U.S. at 451-52.

This Court's decision in *Japan Line* is not applicable to an apportioned income tax. *Japan Line* did not involve a net income tax properly apportioned to reflect activities within a state, but an *ad valorem* property tax levied directly on foreign-owned cargo containers used exclusively as instrumentalities of foreign commerce. The Court specifically noted that:

> The question here is a . . . narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State.

441 U.S. at 444. As the Court noted in *Mobil*, the principles of income taxation are different from those of property taxation.

> Appellant's attempted analogy between this case and *Japan Line* strikes us as forced. That case involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax.

445 U.S. at 448. *Accord, Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228 (1980). The

additional tests set forth in *Japan Line* are therefore not applicable in this case.

Even if this Court finds that the additional tests set forth in *Japan Line* must be satisfied by an income tax, however, the factors that concerned the Court in *Japan Line* are not present in this case. First, no state or country has taxed 100% of the income of Container and its unitary subsidiaries. In *Japan Line*, the containers on which the County of Los Angeles sought to impose an apportioned property tax had already been subjected to a lawfully imposed tax on their full value in Japan. The levying of even an apportioned tax in the United States therefore ensured that the company would be paying a double tax on the containers. No similar double taxation occurred in this case because each state and country in which Container or its subsidiaries conducted business taxed only so much of the income of the business as was earned within its taxing jurisdiction.

Second, the imposition of an apportioned income tax does not prevent the nation from "speaking with one voice" when regulating foreign commerce. 441 U.S. at 451-52. In *Japan Line*, the county's *ad valorem* tax on containers frustrated a national policy, expressed in a Customs Convention on Containers that was signed by the United States and Japan, of removing all impediments to the use of containers as instruments of international traffic. 441 U.S. at 453. No similar conflict between federal and state policy exists in this case. Both the United States and the State of California tax foreign subsidiaries of domestic corporations on income earned within their taxing jurisdiction; only the accounting method employed to identify that income differs. Moreover, California's apportionment formula is consistent

with the treatment afforded to Container in other countries because each jurisdiction in which the business operated taxed only income earned in that jurisdiction.

2. This Court has the power to prevent excessive taxation of income should it arise.

Container's Commerce Clause argument assumes that this Court would be powerless to prevent excessive taxation of income in cases where it is shown to exist. This is not so. The Court stated in *Mobil* that:

> [A]ppellant's argument underestimates the power of this Court to correct excessive taxation on the field where appellant has chosen to pitch its battle. A discriminatory effect on foreign commerce as a result of multiple state taxation is just as detectable and corrigible as a similar effect on commerce among the States. Accordingly, we see no reason why the standard for identifying impermissible discrimination should differ in the two instances.

445 U.S. at 447. If California had exacted an excessive tax, the Court could correct the error by requiring California to alter its apportionment formula. For example, the Court could require California to exclude or modify any or all of the factors in its formula or to include one or more additional factors in order to accomplish an equitable apportionment of the business' income.

CONCLUSION

The Commerce Clause does not require allocation of foreign source income of a unitary business. California's tax on the combined net income of Container and its foreign unitary subsidiaries is constitutional because the income is fairly apportioned to reflect activities of the unitary business in California.

Container has not established that actual duplication in taxation resulted from California's apportioned tax. If an overlap in taxation did occur, it resulted from differences in accounting methods used by nations to determine the source of income and did not result from excessive taxation by California. California's apportionment formula need not yield to the allocation made by a foreign government because the apportionment resulted in a fair allocation of tax obligations. If burdensome duplication had resulted from California's tax, the appropriate mandate of this Court would be an adjustment of California's apportionment formula and not allocation of foreign source income.

Dated at Montpelier, Vermont this 28th day of September, 1982.

Respectfully submitted,

JOHN J. EASTON, JR.
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CERTIFICATE OF SERVICE

I hereby certify that on this 28th day of September, 1982, three copies of this brief were mailed, with first class postage prepaid, to Franklin C. Latcham, Morrison & Foerster, One Market Plaza, Spear Street Tower, San Francisco, California 94105, Counsel for Appellant, and to George Deukmejiian, Attorney General, and Neal J. Gobar, Deputy Attorney General, 110 West A Street, Suite 700, San Diego, California 92101, Counsel for Appellee. I further certify that all parties required to be served have been served.

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NO. 81-523-ASX	TITLE	Container Corporation of America, Appellant v. Franchise Tax Board

DOCKETED	COURT
Sept. 14, 1981	Court of Appeal of California, First Appellate District

DATE	PROCEEDINGS AND ORDERS
	Counsel for Appellant: Franklin C. Latcham
	Counsel for Appellee: Neal J. Gobar
Sept. 14, 1981	Statement as to jurisdiction filed. (Record filed).
Sept. 15, 1981	Motion of National Association of Manufacturers for leave to file a brief as amicus curiae filed.
Oct. 15, 1981	Motion of EMI, Limited for leave to file a brief as amicus curiae filed.
Oct. 15, 1981	Motion of Canadian Imperial Bank of Commerce, et al. for leave to file a brief as amicus curiae filed.
Oct. 14, 1981	Motion of The Committee on State Texation of the Council of State Chambers of Commerce for leave to file a brief as amicus curiae filed.
Oct. 16, 1981	Motion of appellee to dismiss or affirm filed.
Oct. 21, 1981	DISTRIBUTED. 11-6.
Oct. 23, 1981	Reply brief for the appellant filed. (D).
Nov. 12, 1981	Motion of appellant to note probable jurisdiction and to hear the case in tandem with 81-349, Chicago Bridge & Iron Co. v. Caterpillar Tractor, 80-2015, Asarco Inc. v. Idaho State Tax Commission, and 80-1745, F. W. Woolworth v. Taxation and Revenue Department.
Nov. 18, 1981	Opposition to appellant's motion to note probable jurisdiction and hear the case in tandem with other cases filed.
Nov. 20, 1981	DISTRIBUTED. 11-25.
Nov. 30, 1981	The motion of appellant to note probable jurisdiction and to hear the case in tandem with No. 81-349, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co; No. 80-2015, ASARCO, Inc. v. Idaho State Tax Commission and No. 80-1745, F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico is DENIED. Powell, J., OUT.
Apr. 26, 1982	Motion of appellant to expedite consideration of the jurisdictional statement filed.
Apr. 27, 1982	DISTRIBUTED. 4-30.
Apr. 29, 1982	Opposition of Caterpillar Tractor Co., et al. to motion of appellant to expedite consideration filed. (D)
Apr. 29, 1982	Opposition of Illinois to motion of appellant to expedite filed.

(Over)

81-523

Title

No.

DATE	PROCEEDINGS AND ORDERS
Apr. 29, 1982	Opposition of Appellee California Francise Tax Board to motion of appellant to expedite filed.
May 3, 1982	Probable jurisdiction NOTED. Stevens, J., OUT.
May 10, 1982	DISTRIBUTED. 5-13. (Motions of Canadian Imperial Bank of Commerce, et al., EMI, Limited, Committee on State Taxation of the Council of State Chambers of Commerce and National Association of Manufacturers, for leave to file briefs as amicus curiae).
May 17, 1982	The motion of National Association of Manufacturers for leave to file a brief as amicus curiae is GRANTED. The motion of Committee on State Taxation of the Council of State Chambers of Commerce for leave to file a brief as amicus curiae is GRANTED. The motion of EMI, Limited, for leave to file a brief as amicus curiae is GRANTED. The motion of Canadian Imperial Bank of Commerce, et al. for leave to file a brief as amici curiae is GRANTED. Stevens, J., OUT.
June 4,1982	Order extending time to file appellant's brief on the merits until July 31, 1982.
June 17, 1982	Motion of Union of Industries of the European Community for leave to file a brief as amicus curiae filed.
July 17, 1982	Brief, amici curiae. of EMI Limited and Capitol Industries-EMI, Inc. filed.
July 19, 1982	Joint appendix filed.
July 19, 1982	Joint appendix (Exhibits) filed.
July 26, 1982	Brief, amicus curiae, of The Committee on State Taxation of The Council of State Chambers of Commerce in support of appellant filed.
July 26, 1982	Motion of Committee on State Taxation of the Council of State Chambers of Commerce for leave to participate in oral argument as amicus curiae and for additional time for argument filed.
July 28, 1982	Brief, amici curiae, of Canadian Imperial Bank of Commerce, et al. in suppor of petitioner filed.
July 28, 1982	Brief, amicus curiae, of The Coca-Cola Company filed.(Ret'd)
July 29, 1982	Brief, amici curiae, of Sony Corporation, et al. filed.
July 29, 1982	Brief, amicus curiae, for The Gulf Oil Corporation filed.
July 29, 1982	Motion of the Committee on Unitary Tax to file a brief as Amicus Curiae filed.
July 30, 1982	Brief, amicus curiae of Phillips Petroleum Company filed.
July 30, 1982	Brief, amici curiae, of Jeffrey G. Balkin, et al. filed.
July 30, 1982	Brief, amicus curiae, of Firestone Tire & Rubber Co. filed.

(Card No. 2)

No. 81-523-ASX	TITLE Container Corporation of America, Appellant v. Franchise Tax Board

DOCKETED	COURT
Sept. 14, 1982	Court of Appeal of California, First Appellate District

DATE	PROCEEDINGS AND ORDERS
July 30, 1982	Brief, amicus curiae, of Colgate-Palmolive Company filed.
July 28, 1982	Brief, amicus curiae, of The Government of The Kingdon of of the Netherlands filed.
July 28, 1982	Brief, amicus curiae, for Financial Executives Institute filed.
July 28, 1982	Appellant's brief filed.
July 30, 1982	Brief, amici curaie, of Allied Lyond, P.L.C., et al. filed.
July 31, 1982	Brief, amicus curiae, of The Confederation of British Industry filed.
Aug. 2, 1982	Brief, amicus curiae, of Shell Petroleum N. V. filed.
Aug. 2, 1982	Opposition of appellee to motion of Committee on State Taxation of the Council of State Chambers of Commerce for leave to participate in oral argument as amicus curiae and for additional time for argument filed.
July 30, 1982	Motion of International Bankers Association in California, et al. for leave to file a brief as amicic curiae filed.
Aug. 20, 1982	Order extending time to file the appellee's brief on the merits until October 1, 1982.
Sept. 1, 1982	Brief, amicus curiae, of the state of Montana in support of appellee filed.
Sept. 8, 1982	Brief, amicus curiae, of Caterpillar Tractor Co. in support of appellee filed.
Sept. 9, 1982	The motion of Union of Industries of the European Community for leave to file a brief as amicus curiae is GRANTED. The motion of Committee on State Taxation of the Council of State Chambers of Commerce for leave to participate in oral argument as amicus curiae and for additional time for argument is DENIED. The motion of Committee on Unitary Tax for leave to file a brief as amicus curiae is GRANTED. Stevens, J., OUT.
Sept. 24, 1982	Brief, amicus curiae, of the State of North Dakota in support of appellee filed.
Sept. 23, 1982	Brief, amicus curiae, for National Farmers Union filed.
Sept. 23, 1982	Order extending time to file the appellee's brief on th merits until October 14, 1982.
Sept. 30, 1982	Brief, amicus curiae, of the State of Vermont in support of respondent filed.
Oct. 4, 1982	The motion of International Bankers Association in California, et al. for leave to file a brief as amici curiae is GRANTED. Stevens, J., OUT.
Oct. 8, 1982	Brief, amicus curiae, of the State of New York filed.
Oct. 1, 982	Brief, amicus curiae of Idaho and Utah filed.

(Over)

81-523

Title

No.

DATE	PROCEEDINGS AND ORDERS
Oct. 13, 1982	Brief, amici curiae, of Citizens for Tax Justice, et al. filed.
Oct. 7, 1982	Application for leave to file the appellee's brief on the merits in excess of page limitations, and order granting same by Rehnquist, J., 10/8/82, not to exceed 65 pages.
Oct. 14, 1982	Brief, amicus curiae, of Frank M. Keesling in support of appellee filed.
Oct. 14, 1982	Brief, amici curiae, of The National Governors' Association, et al. in support of appellee filed.
Oct. 19, 1982	Brief, amicus curiae, of the State of Illinois filed.
Oct. 19, 1982	Brief, amicus curiae, of Multistate Tax Commission and participating states filed.
Oct. 15, 1982	Appellee's brief on the merits filed. (Volumes I & II).
Oct. 25, 1982	Brief, amicus curiae, of The State of Oregon in support of appellee filed.
Oct. 15, 1982	Brief, amicus curiae of the State of New Mexico filed.
Nov. 5, 1982	CIRCULATED.
Dec. 3, 1982	Motion of appellee for divided argument to permit amicus curiae Multistate Tax Commission to present oral argument filed.
Dec. 13, 1982	The motion of appellee for divided argument to permit Multistate Tax Commission to present oral argument as amicus curiae is DENIED. Stevens, J., OUT.
Dec. 23, 1982	Appellant's reply brief filed. (D)
Jan. 10, 1983	ARGUED.